Asset allocation
A key component of a successful investment strategy



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This guide to asset allocation offers some clear thinking on one of the most crucial of all investment subjects. It's currently one of the most topical, too, with hundreds of articles written about it, and dozens of experts devising their own asset allocation models.

As a result, it's easy to lose sight of the basics. This guide explores:

1. The role of asset allocation and the factors you need to consider.
2. The key characteristics of the major asset classes.
3. The importance of correlation and how it works in practice.
4. The different asset allocation techniques.

From reading this guide, you should gain a good understanding of the fundamentals of asset allocation and the role your financial adviser plays in helping you construct your portfolio.

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The importance of asset allocation

Asset allocation is one of the key ingredients of a successful investment strategy.

Asset allocation simply means deciding how to spread your money across the different asset classes (including equities, bonds, property and cash) and how much you want to hold in each.

We'll look at how this works in more depth later in this guide, but first we need to talk more about you. Asset allocation can help you to achieve your financial aims by combining a range of investments that work together, while taking account of your personal financial circumstances and your attitude to risk.

Your financial adviser can help you to create an asset allocation that suits you.

Asset classes
A category of assets, in which you can invest, for example equities, bonds, property or cash. Investments within an asset class have similar characteristics.

Your current position and future goals

You have to think about your current situation and the lifestyle you would like to lead in your later years.

Putting asset allocation into practice means making hard decisions about which assets to buy and what proportion of each asset to hold.

The first thing to consider is your present financial situation and how much you can afford to invest. Next, you need to think about why you're investing. For many people, investing for the long term is about providing money for retirement. So you have to think about when you might like to retire, and what you would like to do during your retirement.

Working with your financial adviser, you can then design your personal investment plan.

Your plan will depend on several factors, including:

1 Your investment goals.

2 Your investment time frame.

3 Your risk tolerance (attitude to risk and reward).

Remember that your asset allocation will constantly evolve as your personal situation changes.

Key considerations for building your portfolio

1 Your investment goals

You need to consider your goals and the money that you will need to achieve these. This will help determine the asset allocation you choose. We will examine the major asset classes later in this guide.

2 Your investment time frame

How soon you intend to start taking money from your portfolio may influence the type of investments you choose. For example, if you need to withdraw money relatively soon, you may consider having a higher percentage of your investments in cash.

3 Your risk tolerance

Balancing the risk you are willing to accept with the investment returns you need or want will help determine your asset allocation. Your financial adviser can make sure you understand the risks associated with investing in each asset class.

The major asset classes

Investments are divided into different asset classes such as equities, bonds, property and cash. These provide the basic building blocks of an investment portfolio.

The table below highlights the characteristics of the different asset classes and outlines who they may potentially be suitable for. The following pages describe the asset classes in more detail.

Asset class	Key characteristics	Potentially suitable for
Equities	Potential for capital growth, and may offer income through the payment of dividends. You can choose to invest in UK and overseas companies.	Medium-to-long-term investors (five years plus).
Bonds	Can provide a steady and reliable income stream with potential for capital growth and usually offers a higher interest rate, or yield, than cash. Includes UK government bonds (gilts), overseas government bonds, and company loans (corporate bonds).	Short, medium or long-term investors.
Property	Provides the benefits of diversification through access to properties in retail, office, industrial, tourism and infrastructure sectors. You can invest in both UK and international property.	Medium-to-long-term investors (five years plus).
Cash	May be suitable for short-term needs, such as an impending down payment on a new home. Usually includes higher interest paying securities, as well as bank and building society accounts or term deposits (a cash deposit at a financial institution that has a fixed term).	Short-term investors (up to three years).

The major asset classes detail

As part of your asset allocation strategy, you may consider spreading your investments over different asset classes – in other words not putting all your eggs in one basket. This is known as diversification.

Equities

Equities (sometimes called stocks or shares), represent ownership in a company. This ownership gives you the right to share in that company's future financial performance.

Of the major asset types equities have historically shown the greatest potential to deliver over the long term. But remember that equities can be very volatile and past performance is not an indicator of future results.

Global equities

Investing in global equity markets can reduce a portfolio's volatility (how much it fluctuates in response to a particular market moving up or down) and improve its potential returns. This is because UK and international equities may experience ups and downs at different times – though they may also move together, particularly during sharp market falls and rallies (when shares rise quickly following a fall).

While international investments can add diversification to your portfolio, there are also additional investment risks – such as currency risk, liquidity risk and country risk.

We've included a detailed section on investment risks later in this guide.

Bonds

A bond is a loan made to the bond's issuer. This could be a company (known as corporate bonds), a government (UK government bonds are also known as gilts), or some other institution. Typically, the issuer promises to make regular interest payments and to repay the face amount (the principal) of the bond when it reaches maturity.

As bonds typically offer regular payments of a fixed amount of interest, they are sometimes called fixed income investments. Different types of bonds entail different levels of risk. For example, a UK government bond is considered low risk, while a bond issued by a new technology firm which has yet to make any profits would be considered very risky.

Property

For many people, their major investment in property is owning their own home. As this is a high value investment, you may decide that this gives a high enough proportion of property in your portfolio.

However, one way to add to your property investments is by diversifying into commercial property. The simplest way to do this is to invest in specialist property funds, run by professional managers.

You can find property funds that concentrate on the UK or others that let you invest abroad.

Cash investments

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).

Cash investments offer liquidity – the ability to withdraw cash relatively easily and historically have been the least volatile of the major asset classes. However, they also tend to provide the lowest returns and that's why they are generally used for short term saving.

Pooled fund
An investment vehicle in which investors combine their money in a fund, which then invests in a range of securities. Each investor shares proportionally in the fund's investment returns.

Considering your attitude to risk

When considering your asset allocation, it is important to think about risk.

All investments involve some degree of risk.

When evaluating risk you need to think about:

1 Your risk tolerance

2 The different types of risk

Your risk tolerance

Your risk tolerance is the extent to which you are prepared to lose money in return for the prospect of potentially greater returns.

Your risk tolerance will change over time. For example, investors in their 20s may not be too worried about a 30 per cent drop in the market, reasoning they have time to ride it out. Investors in their 40s, however, if they have responsibilities such as a mortgage and a family, may focus more on protecting against this kind of loss.

Different types of risk

Risk has many dimensions Some of the most common risks are outlined below:

Country risk
The risk that domestic events – such as political upheaval, financial troubles, or natural disasters – will weaken a country's financial markets.

Credit (or default) risk
The possibility that a bond issuer will fail to repay interest and capital on time. Funds that invest in bonds are exposed to credit risk.

Currency risk
The risk that changes in currency exchange rates cause the value of an investment to decline.

Inflation risk
Inflation is a measure of the rate of increase in general prices for goods and services. The most familiar measure in the UK is the Retail Price Index (RPI).

The risk that inflation poses is that it can erode the value or purchasing power of your investments.

Interest rate risk
The possibility that the prices of bonds will fall if interest rates rise.

How inflation erodes real value
The 'rule of 72' provides a way of calculating how inflation can eat into the real value of your money over time. Basically, you divide 72 by the inflation rate to give an approximate guide to how many years it will take for your money to halve its real value (that is, your money would be able to buy only half as much).

So, for example, an inflation rate of three per cent per year would mean your money would halve in value over the next 24 years (72 divided by three).

Liquidity risk
The chance that an investment may be difficult to buy or sell.

Manager risk
The chance that a pooled fund will underperform due to poor investment decisions

Market risk
There are risks associated with the majority of asset classes. This is what professionals call market risk. Market risk is the risk that investment returns will fluctuate across the market in which you are invested.

Short fall risk
Short fall risk is a possibility that your portfolio will fail to meet your longer-term financial goals.

Sector risk
The risk that a particular sector within a market, such as the oil and gas sector, or the travel sector, may decline in value. For example, if oil prices surge, the oil and gas sector might rise, but the travel sector might fall due to rising fuel costs.

Specific risk
The risk that a specific share, bond or fund you've invested in performs badly.

Volatility risk
As we saw earlier, different types of investments fluctuate in value over time. This is referred to as volatility and is often used to assess the potential risk associated with an investment.

The importance of correlation

Correlation measures the degree to which two different asset classes move together.

One way to manage risk in your portfolio is by selecting asset classes that are not correlated to each other.

The asset classes all work differently and largely independently. Therefore if one goes up another might go down and vice versa. The extent to which asset classes move together is known as correlation.

Investing with asset class correlation as a guide means balancing investments according to the way they have generally behaved in the past. However, this may not indicate future correlation.

The idea is to choose asset classes that don't tend to rise and fall together. Therefore at any time, there could be one group of your investments doing well, while another may be going down. But the main point is to try to avoid your entire portfolio losing value at the same time.

Correlation
A statistical measure of the degree to which the movements of two different asset classes, such as equities and bonds, are related. When two asset classes have negative correlation, they will tend to move in different directions (as one rises, the other falls). If they have high correlation, they will tend to rise and fall together.

Asset classes with low or negative correlation are good diversifiers, and help you to reduce portfolio risk.

Correlation: the professional view

Investment professionals give different pairs of asset classes specific correlation values, known as correlation coefficients. These range from +1.00 (or perfect correlation, where the assets rise and fall identically) to -1.00 (or perfect negative correlation, where one asset rises as strongly as the other falls).

The table shows how a variety of different asset classes are related, based on an analysis of market movements over the last two decades.

Correlations between pairs of asset classes 1 January 1992 to 31 December 2011

	UK equities	Global equities (ex UK)	Emerging market equities	UK property	UK Government bonds	Cash
UK equities	1.00	0.90	0.68	0.45	0.26	0.08
Global equities (ex UK)		1.00	0.63	0.34	0.27	0.18
Emerging market equities			1.00	0.25	-0.05	-0.10
UK property				1.00	0.01	-0.15
UK Government bonds					1.00	0.34
Cash						1.00

Sources: Thomson Reuters Datastream and Lipper Investment Management. Indices used: UK equities (FTSE All Share), Global equities (MSCI World ex UK), Emerging Markets Equities (MSCI Emerging Markets Free), UK commercial property (UK IPD Property), UK Bonds (FTSE British Government All Stocks (1992 – 1999)/BarCap Sterling Aggregate (2000 – 2011), Cash (3-Month LIBOR)

From the data, it can be seen that the UK equity market, as represented by the FTSE All-Share Index, is most closely correlated with other equity markets although less so with emerging markets equities which tend to be more volatile. Cash on the other hand is negatively correlated with all the other asset classes except UK bonds.

Past performance is not a reliable indicator of future returns.

Techniques for successful asset allocation

Asset allocation is as much an art as a science. However, there are a number of techniques, supported by extensive academic research, that your financial adviser can use with you to help you achieve an appropriate asset allocation.

As we've already considered, every investor will have a different asset allocation which will change over time.

But how should you go about the mechanics of asset allocation? Fortunately, there are a number of models you can follow.

However, it is important to point out that there is no standard solution, and you could settle on hundreds of different ways of combining investments depending on your situation and goals.

Over the next few pages, you'll find some examples of different techniques you or your adviser may use to determine your preferred asset allocation.

These include:

- Using a traditional asset based approach.
- Defining your asset allocation by age.
- Determining your asset allocation by risk profile.
- Selecting investments by style type, industry and geographical diversification.

Traditional, asset class based approach

You can begin by combining the key asset classes. The charts on the opposite page provide hypothetical asset allocation splits which an investor may consider.

These illustrate how your asset allocation mix may vary depending on your goals and your attitude to risk and are categorised into three portfolio types, including:

1 Adventurous

2 Moderate

3 Conservative

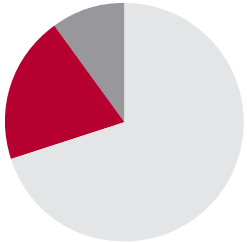
Portfolio types

The **conservative** portfolio has a low proportion of equities, and may suit those with low risk tolerance and/or a short time to invest.

The **moderate** portfolio has a lower percentage of equities compared to bonds, and may suit investors with medium risk tolerance and/or a medium investment time frame.

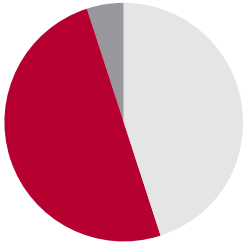
The **adventurous** portfolio, with a high proportion of equity-based investments, may suit investors with high risk tolerance, and/or those with a long investment time frame.

Conservative portfolio



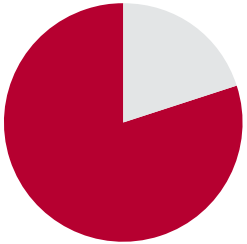
20% Equities
70% Bonds
10% Cash

Moderate portfolio



50% Equities
45% Bonds
5% Cash

Adventurous portfolio



80% Equities
20% Bonds
0% Cash

These examples are hypothetical portfolios, and are provided for illustration purposes only. They are not a replacement for financial advice.

Your adviser has access to sophisticated asset allocation tools, based on a broad base of academic reseach, that can help you construct a portfolio that is appropriate for your level of risk tolerance and investment goals.

Asset allocation by age

If your purpose for investing is to save for your retirement, the proportion of equities to bonds that you hold may vary with your age.

At the simplest level, this means that the younger you are, the more likely you are to have a higher proportion of relatively high risk investments, such as equities, in your portfolio. As you get older, you are likely to want to hold a smaller proportion of equities, and a larger proportion of less volatile assets such as bonds.

The following formula adjusts asset allocation according to an investor's age. It is important to highlight that this is just an example and only you can decide whether this approach is suitable for you. As ever, please consult your financial adviser.

Your age = your bonds

With this approach arrange your portfolio so that the percentage of your assets you hold in bonds is the same as your age.

That's it. So if you're 40, your portfolio should have 40 per cent bonds. If you're 60 your portfolio should have 60 per cent bonds, and so on.

Asset allocation by risk profile

Another way to organise your asset allocation is to concentrate on your attitude to risk.

A risk-based model looks at how much money you think you could bear to lose – a very straightforward way of gauging your risk profile – and uses this to recommend the proportion of equities you should have in your portfolio.

Your adviser can help by using carefully designed questions that reveal your tolerance to risk.

Asset allocation over time

Nothing in the investment world is fixed forever. This applies both to your personal situation, and to the assets you invest in.

Once you have defined your asset allocation strategy, the temptation may be to leave it untouched. However, markets seldom stay still for long and therefore it is wise to schedule regular reviews with your financial adviser. This will help to ensure that your portfolio reflects your current aims and attitude to risk, while not leaving you over exposed to any particular asset class or sector.

During your review some things to consider include:

1 Whether your asset allocation needs to be revised to reflect a change in your goals or current situation.

2 Whether your asset allocation needs to be rebalanced because it has drifted out of sync as a result of market movements.

Rebalancing

A portfolio is rebalanced when the percentage holdings of each asset class it contains are increased or decreased to return the portfolio to its original weighting, or to reflect new goals.

Selecting investments by style type, sector and geographical diversification

Selecting equities by style type. Broadly equities can be divided into two types – value (or income) and growth.

When developing your asset allocation, your adviser will consider factors such as whether your portfolio should be weighted towards growth or value (income) shares and the degree of diversification you require across countries and industries.

Value (income) shares tend to be perceived 'bargains', – perceived as being undervalued by the market and trade at a lower price than seems justified by the level of profit the company makes.

They tend to pay an above market average dividend (they are called income shares for this reason), and typically have a comparatively low price-earnings ratio.

Growth shares are bought because investors expect the companies they represent to grow their profits faster than the market or sector average.

Fund managers and investment professionals use various methods and tools to identify the most appropriate asset allocation mix, to suit different investment objectives.

Price earning ratio
This is the price paid for a share divided by the annual profit earned by the firm per share. A stock with a price of £10 a share, and earnings last year of £1 a share, would have a price earning ratio of 10.

Selecting investments by sector diversification

It is also important to consider balancing your holdings by industry sector (companies operating in the same industry and sharing similar characteristics). If you are aiming to diversify your holdings, you don't want to be over-invested in any one sector, any more than you'd want to be over-invested in one asset class, or in value shares or growth shares.

Examples of sectors include mining, property, oil and gas, pharmaceuticals and retailers. By holding investments across different sectors you can protect yourself against the risks of one or more sectors underperforming.

Selecting investments by geographical diversification

This helps to protect you against being over-reliant on the performance of one country or region.

You can diversify your portfolio, across UK and international equities. You may also consider diversifying your bond portfolio in this way.

One of the most effective ways to diversify is through an investment fund. Funds are available that invest across particular countries, sectors or regions and which have different investment objectives such as growth or income.

As ever, the trick is to spread your investment among different baskets.

It is important to note that when you invest overseas you are also taking on currency risk – the chance that international investments can rise or fall in value with fluctuations in currency exchange rates.

Sector
A distinct subset of a market or industry. Stocks are often grouped by the nature of the company's business, such as utilities or health care. Different sectors can react differently to economic or market events.

How to rebalance your asset allocation

You should review your portfolio annually to make sure your asset allocation stays on track.

If you need to change your asset allocation, you may need to sell some investments and buy others, to ensure the mix suits your goals and your attitude to risk.

You can rebalance your investment portfolio in three ways:

1. Reinvest dividends. Direct dividends from the asset sector that has exceeded its target into one that has fallen short.

2. Top up. Add money to the asset sector that has fallen below its target percentage.

3. Transfer. Move funds between asset classes. Shift money out of the asset sector that has exceeds its allocation target into the other investments.

When you rebalance, you need to think carefully about the costs and tax implications. For example, when buying equities or bonds, you will have brokerage costs and with some pooled funds you may be asked to pay an entry or exit fee. You may also have a capital gains tax liability if a sale of assets means you go above your annual allowance.

When deciding whether or not to rebalance, you and your adviser should weigh the benefits of adhering closely to your asset allocation strategy, with the costs of rebalancing too frequently.

What next?

As you now have a greater understanding of asset allocation, you can work with your adviser to put together a mix of assets that may ultimately help you to reach your investment goals.

Your job is to work with your adviser to pick the ideal team, adding and dropping players as appropriate over time.

For further information on how asset allocation can work for you, please contact your financial adviser.



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