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## Asset Allocation – Risk and Return

### Summary

1. Before making any investment decision, individuals should consider the level of risk that they are prepared to accept in light of their aims and objectives. A fundamental rule of investing is that generally the higher the risk the higher the potential returns, and vice versa.
2. Individuals should also consider the timescale over which the investments are to be held.
3. A suitable asset allocation targets the desired level of return for as little risk as possible, and vice versa. Factors such as diversification and the effect of inflation are important considerations.
4. It is important to keep emergency funds and short term spending reserves separate from the amount specified for long term investment.

### Asset Allocation

Asset Allocation involves the process of deciding how to spread an investment between categories of financial assets (including equities, bonds and cash) and tangible assets (including real estate, commodities, precious metals and collectibles). Asset allocation is generally driven by three main factors:

1. The desire to optimise the risk-return trade-off.
2. Investment timescale.
3. Other investment objectives, such as a requirement for income or capital growth.

For these reasons, it is impossible to specify a ‘one size fits all’ asset allocation. The target allocation will depend on the investor’s objectives and tolerance of risk. However, it is possible to use asset allocation models to set broad parameters which most advisers will use as a starting point when establishing an individual’s target allocation.

An asset allocation model only applies to those funds that can be put aside for long term investment. Shorter term spending requirements and a sufficient emergency cash reserve should be provided for by separate cash savings.

### The Risk-Return Trade Off

One of the most critical issues for investors is the level of risk they are prepared to take. The term risk generally means the degree by which the achieved outcome might differ from the expected outcome. Investors are clearly more concerned with minimising the downside risk, i.e. the proportion of their funds they could lose, rather than the upside risk, i.e. the level of profit they could make. However, it is critical for the investor to understand is that it is often necessary to take risks to achieve greater rewards; it is impossible to have exposure to a high level of upside risk without also being exposed to the equivalent level of downside risk. In this sense risk should be seen as a factor to be taken into every investment calculation rather than a problem.

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Any investor would be unhappy with the prospect of losing a significant portion of their investment, but it is a fundamental feature of most investments that some degree of risk must be taken, in order to create the potential to achieve investment returns above the “risk free” rate. Finance theory often uses this risk free rate (usually the return on government bonds) in valuation and optimisation models, but from the investor’s perspective an investor unwilling to take any risk would probably place their funds in cash - such as high interest savings accounts - and it is the interest paid on these accounts that could be considered the risk free rate of return.

Those who are prepared to accept the risk of losing a proportion of their assets in return for potentially greater rewards are more likely to invest in equities. Even here there is a risk spectrum, for example there is a large difference between investing in a fund of blue chip companies in developed Western markets and investing in an emerging markets fund.

The level of risk taken by fund managers is a significant determinant of performance. It is not difficult, with some luck, for a manager to make a high return by betting on a few high risk shares. However, achieving an optimal level of long-term return for a controlled level of risk is a more difficult task.

An investor should look at his objectives and attitude to capital loss when considering attitude to risk. One should consider what one is prepared to lose, not what one would be happy to lose (i.e. nothing), and whether the investment objective set is achievable.

## Factors Affecting Risk

### *Timescale*

The risk assessment of the individual investor should also take into account the timescale of the proposed investment. A high-risk asset class is one where the value fluctuates significantly - known as volatility - such as with equities. Historically, equity returns over the longer term have generally been less volatile than over short term periods. This is why equity investment is generally not recommended for investment periods under 5 to 10 years, and why the perceived risk of investing in equities diminishes as the timescale for investment grows longer.

As an example, the figures below take every monthly starting point over 30 years, and calculate the number of times that an investment will have lost money over a set investment period. (source: Fidelity Research 1.2.73 to 1.2.03, Standard & Poor’s, FTSE All Share, net income reinvested, cumulative returns over 1,5, and 10 years on all eligible time periods at one month start intervals). Clearly, these figures use historical data and do not attempt to predict future returns.

- Over 1 year, an investment in UK equities will have lost money 19.5% of the time.
- Over 5 years, an investment in UK equities will have lost money 1.7% of the time.
- Over 10 years, an investment in UK equities will have lost money 0% of the time.

However, this is not to say that equities are a low risk proposition for long term investment, as the investor will still be exposed to short term volatility at investment and disinvestment (although there are phasing strategies that can be undertaken to average this exposure). In addition, it is important that the investor is prepared to see their fund value fluctuate strongly over the shorter term without it causing unease - a common scenario is where the investor sees short term market falls affecting their investment, and sells at a market low, even though their investment timescale is a long term one. This is explored further under the market timing section below.

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## Diversification

Introducing a suitable level of diversification into a portfolio can optimise the level of risk for a given level of return. For example, an investment in a single share will be fully exposed to the volatility (risk) and return of that one share. However, an investment in two shares, which are equally volatile and have an equal level of potential return, but where the factors affecting volatility are different, will have a lower overall volatility for the same level of expected return. The typical example used in the latter scenario is that of shares in an umbrella company and an ice cream company, which will clearly do well at different times depending upon the prevailing weather conditions.

This relationship between how the shares perform at different times is known as ‘correlation’, and the basic principle of diversification is to reduce the correlation between investments within a portfolio as much as possible, without reducing the potential return. The principle of diversification applies at all levels, from the top level of deciding exposure to asset classes (e.g. the commercial property market is only loosely correlated with the equity markets), to gaining sufficient diversification within asset classes (e.g. gaining exposure to different geographical and economic sectors, and investment styles).

## Factors Affecting Returns

### Inflation – Effect on Cash

The effect of inflation is to continually eat away at returns from all investments. For example, if the UK inflation rate stands at 3%, any investment must generate an after-tax return of at least 3%, in order that the cash sum will have the same spending power a year later. If a typical high interest bank account paid 5% interest (and many pay much less than this), the real rate of return, in terms of spending power, would be around 2%. If you take income tax into consideration, the net real rate of return would be zero for a higher rate taxpayer, and 1% for a basic rate taxpayer.

Therefore, there is a risk that investing in cash over the medium to long term will reduce the real value of your investment. In reality there are very few ‘risk-free’ investments, and an investor must think carefully about the level of risk he is willing to accept.

### Inflation and Real Returns

Many investors look at absolute performance over very short terms. However, the figures relevant to the investor are those over the period in which they actually intend to invest, after taking into account the effects of inflation, rather than the gross returns unadjusted for inflation.

The investment market is generally split into four broad asset classes: cash, gilts/bonds, property and equities. The table below illustrates the real annual returns delivered by each asset class, in the UK, over varying periods of time (source: Barclays Equity-Gilt Study 2006).

Period	100 years (1905 - 2005)	80 years (1925 - 2005)	50 years (1955 - 2005)	50 years (1905 - 1955)	10 years (1995 - 2005)
Cash	0.9	1.1	2.0	0.7	2.9
Gilt	1.2	2.0	2.1	0.7	5.6
Equity	5.3	6.1	6.6	5.3	5.0

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The historic returns on commercial property are difficult to gauge, as there is no recognised index, but the conservative return on “Blue Chip” property is probably at least 3.0% per annum over and above inflation.

Clearly, it is impossible to predict future returns over a specific period by looking at past returns. If much shorter historic investment periods are taken, then returns can differ significantly, as seen with the 10 year figures above, which include a prolonged equity bear market.

### *Investment Timing*

Long term investors often focus unduly on market timing. Precisely because of short term volatility, it is extremely difficult to ‘call’ the lows or highs of the market, and we believe that attempting to do so only adds to the risk of investing. This is for a number of reasons, including the following:

- It is very easy to miss the gains. Equity returns are volatile, and this means that sharp falls are often preceded and followed by sharp rises. Attempting to time the market means that it is easy to miss these rallies, which can be a large constituent of overall returns.
- It may not make a large difference to overall investment returns over the long term. When you compare this to the additional risk involved in missing rallies, the potential additional return may well not be proportionate. For example, the figures below compare the differing returns achieved over 30 years by investing on the best day each year (i.e. the lowest market point), the worst day, and a random date of 1 January. The best day strategy produced average annual returns of 14.5%, the worst produced 12.4%, and the random date produced 13.7%. The difference between these figures is much lower than many investors may expect, and presupposes that the investor is able to get it precisely right every single year (source: Fidelity. Investment each year from 31.12.72 to 31.12.02, showing annualised total return over that period on MSCI UK index).

### *The Fallacy of Percentage Return*

Take a highly volatile fund such as one investing in Korea or Russia. If the fund loses 50% in one year then gains 50% the next many people would assume they have regained their initial investment. That is certainly what many fund groups would like investors to believe.

But on closer inspection the investor has made a substantial loss. If his initial investment were £1,000 a loss of 50% would leave him with £500. And if the fund gained 50% the following year he would be up to £750. Overall he would still have made a 25% loss on his initial investment.

There are numerous variations on this fallacy. The basic problem to be aware of is that investors generally tend to underestimate the impact of compounding on their investments. For instance, bond investors often do not fully grasp the extent to which several years of inflation will erode the capital value of their investment. A more positive example is how investors in shares often underestimate the benefits of a slow but steady increase in the value of their assets when it is compounded over several years.

### *Taxation*

Clearly, the relevant rate of return to an investor is that which is received after any tax due on the investment has been paid. Therefore, once an appropriate asset allocation strategy has been set, the next step would be to look at the most tax efficient way to make the investments. When considering tax-favoured investments, the primary consideration is that the investment dovetails with the overall

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investment strategy. The tax benefits of an investment should simply be an added bonus, rather than the main motivation for investment.

For example, an investor who wanted to put aside £3,000 for a house deposit in 2 years time should almost certainly not invest the funds in an equity ISA, as the capital would not be secure, even if the ISA wrapper were tax efficient. In this case, the funds would be better placed in a cash style account. On determining this, the investor should then look for tax efficient ways of gaining the best rate, and could then consider a cash ISA for the tax advantages.

### Asset Allocation Revisited

Once all of the above factors concerning risk and return, and additional factors such as a requirement for a certain level of income, have been taken into account, a suitable asset allocation can be constructed.

Some models are constructed using optimised historical data; however, historic performance may not be repeated in the future, and almost certainly not over the particular period of investment in question. Some models also use economic predictions to determine suitable allocations. However, these are just that – predictions – and can only be based upon past experience, which again may not be valid over the period in question. Whilst taking on board the validity of some aspects of these methods, we also believe it is important not to forget the investor’s individual opinions in setting the target, and coming to a solution that is well diversified, giving exposure to a wide range of investments and is appropriate given the investor’s tolerance of investment risk.

For example, for a ‘mid-life’ investor aiming for capital growth balanced with the potential for some income, and with an average tolerance of investment risk, a starting point may be:

Asset Class	Asset Allocation	Regional Equity Allocation
<b>Fixed Interest</b>	30%	-----
<b>Equity</b>	65%	-----
UK Equity	-----	65%
US Equity	-----	14%
European Equity	-----	14%
Far Eastern Equity	-----	3%
Japanese Equity	-----	4%
<b>Commercial Property</b>	5%	-----
<b>Total</b>	100%	100%

It is important that any target allocation is reviewed periodically, to rebalance the asset classes, and to keep it in line with the investor’s attitude to risk and objectives.

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