Alchemy
Advisory Services Ltd

KEY GUIDE

Investment planning and asset allocation

No longer an art form…

Investment planning is now more of a science, rather than an art. Technology, ever-increasing investment opportunities and stricter regulation have all encouraged the more scientific approach. But has your investment strategy kept pace?

Your investment plans would probably benefit from careful examination if:

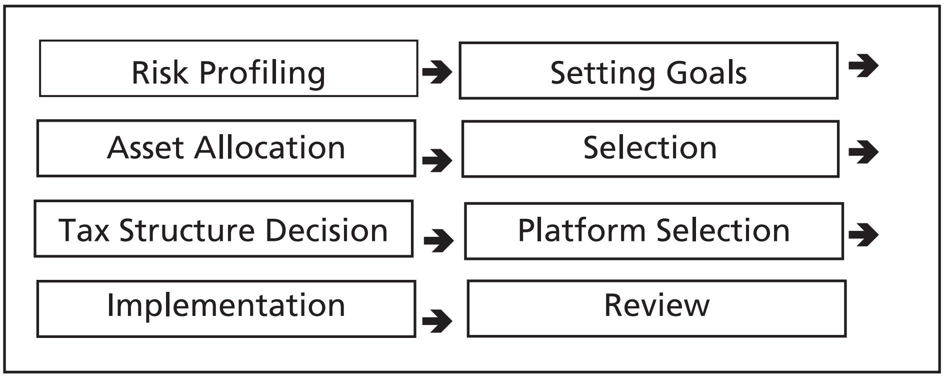
- Your investment holdings have not been reviewed in the last year.
- Your financial objectives have changed since your holdings were last reviewed or are likely to do so in the near future.
- You are still holding funds you bought more than ten years ago, for example those only purchased in an early individual savings account (ISA) or even a former personal equity plan (PEP).
- The investments underpinning your pension arrangements have not been considered in setting your investment strategy.

Action point

Make sure your investment adviser helps you to understand the risks in the investment planning process. You should never be in the position of saying, "I didn't know that could happen".

Investment planning and asset allocation is a multi-stage process. The actual execution of investment transactions is virtually instantaneous, but the decisions behind them need time and should not be hurried. There are many different approaches to the investment planning and asset allocation process, but most will broadly follow the step by step framework in the diagram below.

An example of the investment planning and asset allocation process



The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and your financial circumstances.

A few words about risk

Risk is at the heart of many investment decisions and, as the diagram above shows, it is typically at the starting point of the investment planning process. There could be several types of risk in any investment. Helping you to understand the risks is a key responsibility of your investment adviser. You should never be in the position of saying, "I didn't know that could happen."

For example, putting cash in a bank or building society provides security of the capital and (usually) a miniscule level of interest. But even the 'safety' of deposits can be compromised by a bank failure, as events since 2007 have made all too clear. A subtler – and increasingly obvious – risk for deposits is inflation. Over the years, this has often negated most or all the interest earned once tax is taken into account. The eroding effect of inflation is particularly relevant at present because of:

- The historically low level of deposit rates – base rate was cut to 0.5% in March 2009 and further reduced to 0.25% in August 2016. However, between March 2009 and January 2017 annual CPI inflation averaged 2.2%.
- The post-referendum economic uncertainty means that the Bank of England is unlikely to increase rates any time soon, even though inflation is increasing and set to rise beyond the Bank's 2% target, because of the weakness of the pound since 23 June.

In theory, the higher the investment risk you are prepared to accept, the greater your potential returns. However, a higher return from higher risk is not a certainty; if it were, there would be no risk. While the process of portfolio construction now includes sophisticated strategies to reduce risk, it cannot be eliminated.

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

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

Action point

You would not start on a journey without knowing where you want to go. The same principle applies to investment planning: you need to decide what you are trying to achieve with your capital before making any investment.

Key points in planning your investments

Setting your goals

You would not start on a journey without knowing where you want to go. The same principle applies to investment planning: you need to decide what you are trying to achieve with your capital before making any investment. For example, you might want to produce a specific level of income or aim for a capital sum at a future date. Different investment objectives require different strategies.

Those objectives need to be realistic: if you want a high income, you cannot also expect similarly high capital growth. Also, you need to be comfortable with the goals you have set and stick with them until your circumstances prompt a change. If your aim is long term capital growth, then you should not expect to outperform deposit returns every month. Goals cannot be changed retrospectively, no more than investments can be made with the benefit of hindsight.

At the goal setting stage you also need to consider whether there are any ethical constraints you wish to place on your investments (which could reduce your overall return or increase your risk). The environmental, social and governance (ESG) aspects of investment have become increasingly relevant to individual and institutional investors. There is now over £13.5bn invested in UK green and ethical retail funds according to Vigeo Eiris, an ethical investment research organisation.

Asset allocation

There is considerable academic research to show that asset allocation is a crucial factor in determining overall investment returns. This is well illustrated by looking at the Investment Association (IA) sector fund performance over various terms. The table below shows the last five calendar years. Selecting the best performing fund in the worst performing sector was only more rewarding than choosing an average performer in the best performing sector in 2014, when a sub-£3m minnow of a smaller company's fund shot the lights out – none of the other 45 funds in the sector returned more than 9.5%.

IA sector performance

	Best performing sector		Worst performing sector	
Year	**Sector**	**Average fund**	**Sector**	**Top fund**
2016	North American Smaller Companies	+40.0%	Short Term Money Market	+0.3%
2015	European Smaller Companies	+19.3%	Global Emerging Markets	-10.2%
2014	UK Index-Linked Gilts	+18.6%	UK Smaller Companies	24.5%
2013	UK Smaller Companies	+37.42%	Global Emerging Bond	-3.1%

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

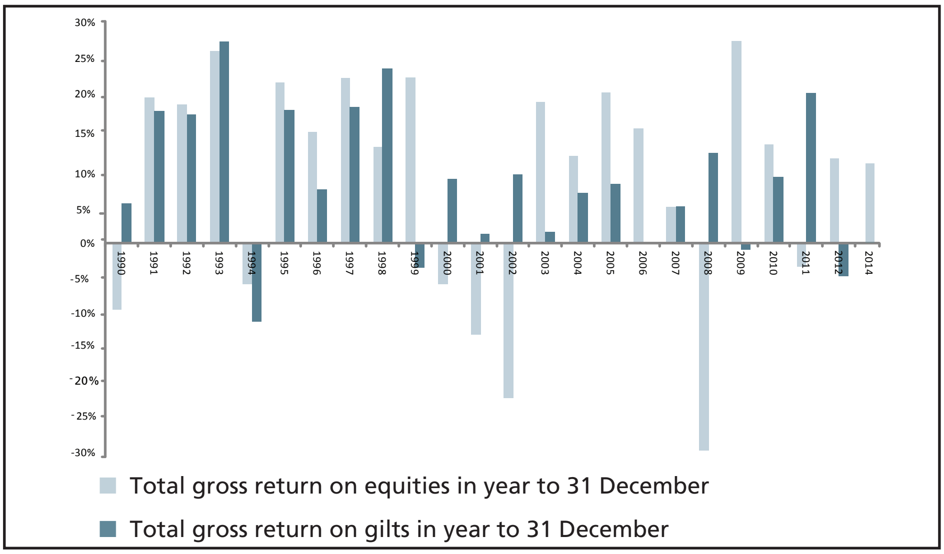
Action point

At the goal setting stage you also need to consider whether there are any ethical constraints you wish to place on your investments (which could reduce your overall return or increase your risk).

Asset allocation is not just about picking asset sectors. As the table also shows, the top sectors are often at the more volatile, higher end of the risk scale such as the smaller companies sectors. For example, while the European Smaller Companies sector was top in 2015, it was the second worst performer in 2014 (Source: Trustnet.com).

The asset allocation decision is especially important in the management of risk. Diversifying across different asset classes, such as UK shares, foreign shares, fixed-interest securities, property and commodities, can reduce your investment portfolio's volatility. What is bad news for one asset class might be good news for another. For example, a jump in inflation can be negative for fixed-interest securities, but it may be positive for index-linked government bonds. The same can hold true for individual shares. For example, the Brexit vote proved to be good news for multinational businesses, such as Unilever, but bad news for UK commercial property companies, such as British Land.

UK Equities v Government Bonds: 1990–2016



Source: Based on Barclays Capital Equity Gilt Study 2016/FTSE

Action point

Fund selection is not a simple matter of looking at a set of performance league tables and picking one of the top three.

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

The process of matching asset allocation to your risk profile and investment goals is now one that can rely on computing power. This allows a portfolio to be constructed that takes account of the historic performance relationships or correlations between asset classes. As the graph above shows, gilts and equities often move in the opposite direction – a negative correlation. So a 50/50 combination of equities and gilts frequently produces more stable returns than either class alone. In the five years to the end of 2016, the 50/50 mix provided a return roughly half way between the two classes with much less volatility.

Smoothing returns

Year	Equities	Gilts	50/50 Mix
2012	12.10%	4.80%	8.45%
2013	20.50%	-7.20%	6.65%
2014	1.20%	18.3%	9.75%
2015	1.10%	0.50%	0.80%
2016	**16.8%**	**1.8%**	**9.3%**
Average Total Return	**10.05%**	**3.70%**	**6.36%**

Past performance is not a guide to the amount you will receive in the future. Equities are further down the capital structure and therefore typically offer investors a higher return for taking on higher risks. Bonds are low risk, and offer modest returns. In addition, equities have the added benefit of offering the potential for dividend growth, while generally bonds offer investors a fixed coupon.

Fund selection

Once the asset allocation has been set, the next decision is how to invest in the selected asset classes. For most private investors, that will mean using collective funds, such as unit trusts and open-ended investment companies (OEICs). The direct purchase of assets rarely makes sense because of the costs involved and/or the difficulty of achieving an adequate spread within the asset class. Even for the wealthiest private investors, collective funds may be the only option for some asset classes, for example commercial property.

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

- Adopted an unacceptably high-risk strategy.
- Performed well while the fund was small, but may now be much larger and less nimble.
- Recently lost its lead manager to another investment group.
- Just struck lucky. The fact is that luck can play a role in fund performance, particularly for more concentrated funds that have few relatively large holdings.

Action point

Tax is not directly relevant to the design of an investment portfolio and should never dictate an investment decision. If tax saving is the sole motivation for your investment, then warning bells should sound.

The uncertainties about *future* fund performance have prompted the increased use of index-tracking funds. They are often called ‘passive’ funds to distinguish them from ‘active’ funds where decisions are made by an investment team rather than an index setter.

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

Tax structure

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

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

Some investments are better suited to being held in tax wrappers rather than directly. For example, income from fixed-interest funds is free of UK tax in an ISA, but currently fully taxed at rates of up to 45% if held personally.

Platform choice

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

The number of platform providers has grown in the past ten years, although there have also been some disappearances. Your adviser will consider a range of factors when recommending a platform to you, including:

- The choice of funds and investment managers – generally the more the better.
- The range of tax structures available.
- The provider's record for administrative efficiency.
- The level of fees charged and their collection method.
- The financial strength of the platform provider.

Review

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

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

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

How we can help

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

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

The value of investments and income from them may go down and you may not get back the original amount invested. Past performance is not a reliable indicator of future performance.

Tax planning is not regulated by the Financial Conduct Authority.

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