

The lion tamer's deception - how investing is not that scary

This guide aims to help you see past the noise created by the markets and media and concentrate on the decisions which will make the greatest improvement to your financial well being.

Just as a circus lion tamer uses chairs and whips to fool you into thinking that the lion is a wild and scary beast, so the investment industry uses jargon and other tactics to make you think investing is somehow mysterious or difficult.

Investing is actually not that complicated. You just need to know which decisions are important and which are not. Then with help from the Jargon Buster at the end of this guide – which explains the terms in *italics* – you are up and away.

Why should you invest?

Why not leave your money as cash in the bank, or even stash it all under the bed? This is a good question and we can think of three occasions when your money should not be exposed to the risks associated with long-term investments:

- 1. When you will need to access the money in less than five years**
Investing is a long-term game. A short-term punt on the markets is *speculating* not *investing*.
- 2. When your emotional tolerance to *investment risk* is low**
If changes in the value of an investment become too great for your comfort you may sell when prices are low or jump into a market when prices are high: the opposite of successful investing.
- 3. When you have enough cash to meet your goals, without the need to take investment risk**
If you can fund your long-term needs from *savings*, why expose yourself to unnecessary risk?

Unfortunately, exposure to some investment risk is necessary for most of us. Over the long term, inflation reduces the purchasing power of cash (especially after tax and costs are taken into account). To make your money grow faster than inflation over the long term, you need to invest some of your money in Growth Assets, such as company shares. Unfortunately this also means having to accept that your investment may fluctuate in value over short periods.

Creating the right relationship between short-term investment risk and long-term reward is crucial for a successful investment experience.

Keep your eyes on the prize

What is it for?



The most important thing you can do to maximise your chance of a successful investment experience is to be clear about why you are investing in the first place.

Financial products tend to be good for one purpose but very poor for others. It is important that you have a clear idea of your financial targets and time horizons.

Working out your required rate of return after inflation is a good way to clarify your financial goals into one easily understood number. PageRussell does this for clients as part of our financial planning process. This is why we recommend that our clients have a regularly reviewed financial plan in place.

Risk

Next we need to establish what your own emotional tolerance to investment risk is. This is tricky.

Investment risk tolerance is a relative measure, just like judging temperature. You know what you think is “hot” or “cold”, but this will be different to what other people perceive as hot or cold. To agree on the exact temperature we need universal scale like a thermometer. Advisers who rely only on their own subjective judgement of their clients’ tolerance to investment risk will judge their clients risk tolerance relative to their own. This inherent ‘adviser bias’ is dangerous. Advisers need the equivalent of a thermometer for investment risk.

To obtain a more scientific measurement of your attitude to investment risk PageRussell use the risk profiling services of Finametrica Corporation. Their Risk Profiling system has been developed using established disciplines for psychological testing which exceed international psychometric standards. It’s possible to use Finametrica’s technology for yourself at www.myrisktolerance.com.

Rise above the noise

The next step to beating the investment Lion Tamers at their own game is getting your investment philosophy right. The two most important money management questions are:

1. Is successful market timing possible?
2. Is superior security selection possible?

Most investors will fit into one of four world views depending on their answers to these questions.

		1. Is Successful Market Timing Possible?	
		YES	NO
2. Is Superior Stock Selection Possible?	YES	NOISE Quadrant 1 Most individual investors Financial journalists	CONVENTIONAL WISDOM Quadrant 2 Financial advisers Stock brokers Most fund managers
	NO	TACTICAL ALLOCATION Quadrant 3 Pure market timers Asset allocation funds	INFORMATION Quadrant 4 Academic research Most institutional funds

The **Quadrant 1** investor expects to both profitably predict the short-term movements of different asset classes and choose securities which will outperform the asset class as a whole. Most individual investors fall into this quadrant with the encouragement of the media.

Quadrant 2 investors (including most investment professionals) know they cannot predict market swings accurately. But they believe it is possible to choose the securities within a particular market that will outperform the market as a whole.

Quadrant 3 investors believe that whilst there is no point selecting individual stocks within an asset class, they can maximise gains by jumping from one asset class to another.

The strategies described by Quadrants 1 to 3 are known collectively as active strategies. The reality is these methods fail to even match the market return, particularly after costs and tax over the long term.

The **Quadrant 4** investor believes that markets are efficient, and that security prices are moved in the short run by surprises that people cannot foresee. Or at least, markets are efficient enough so the costs of Active money management strategies outweigh any small advantages gained. This is our world view and the one backed up by most academic studies. This world view demands that advisers don't concentrate on the money, but on the client and their targets and risk profile instead and structure their portfolio accordingly.

Whilst it is not possible to consistently beat the market by timing or picking stocks, the good news is we don't have to do either to have a successful investment experience.

This may be the first time you have been asked to accept that the Quadrant 4 or Passive Asset Class investing is the optimum money management strategy. So let's look at some of the reasons why Passive Asset Class investing is not as widely accepted as PageRussell believes it should be.

Individual investors

It is a central tenet of western culture that if you work hard enough success will follow. So it is intuitive for people to believe that if they (or their financial adviser) turn over enough stones they will find some gems. The facts are that this is not the case with investing. The main reason for this is the market is not made up of amateurs, but sophisticated professionals. The investment banks now have computers constantly scouring the internet for news and executing trades based on that news within 10 milliseconds. The other reason is that this trading activity costs money, which outweighs any potential gains from the stock picking or market timing.

Humans are driven to want ever more. It is one of the fundamental drivers of human evolution and progress. So it is not surprising that investors are reluctant to accept, 'just' the market return and are susceptible to promises (implied or otherwise) of better than market returns.

Accepting the Quadrant 4 world view means accepting there is no such thing as a free lunch. The benefit of long-term return of capital markets comes with uncomfortable short-term volatility. This is a harsh reality for most investors to accept; it is no wonder they stick with their hopes.

Investment professionals

Most investment professionals reject the Quadrant 4 view as it threatens their existence.

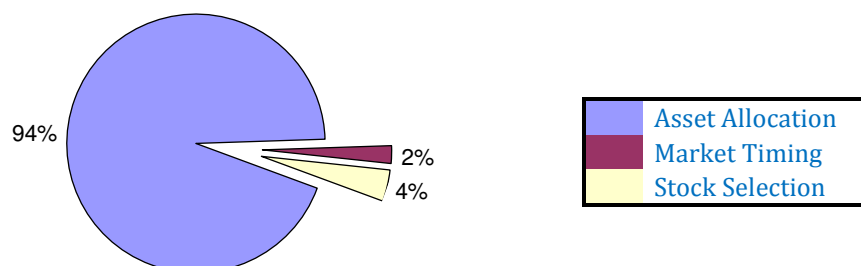
The financial media

The job of financial journalists is to write exciting stories. The media will always either highlight the latest financial scandal (fear), or feed the notion that you can beat the market (greed). The Quadrant 4 world view is too boring to keep writing about.

It would be nice if all our clients came to us already knowing that passive asset class investing is the optimum strategy. But we need the majority of investors to believe they can beat the market. We want them to go on expending the effort, because that creates the market returns we harvest.

The good news

The good news is we don't have to be market timers or stock pickers to have a successful investment experience. This is because investment mix – or *asset allocation* - accounts for over 90% of the performance of an investment portfolio.



Source: "Determinants of Portfolio Performance," Brinson, Hood and Beebower, Financial Analysts Journal, July / August 1986.

Growth assets and defensive assets

Investors are faced with a bewildering range of jargon to describe the funds they can use to allocate their investment assets. Fortunately, any investment fund, whether described as "Balanced Managed" or "Special Situations", will be made up of one or more of the following four main *asset classes*:

- Cash,
- *Fixed interest* (also called bonds),
- *Equities* (also called company stocks and shares), or
- Commercial property (factories, shops and offices).

It might make sense to think of these different investment assets classes as different flavours. The four main asset classes (or investment flavours) can be split into two types to make things even simpler:

- **Growth Assets**

Equities and commercial property grow faster than inflation over the long term, but their values will be more volatile than you may be happy with over the short term.

- **Defensive Assets**

Cash and fixed interest (or bond) returns are lower than those of the Growth Assets over the long-term, but so is their volatility.

Defensive Assets are added to portfolios to counteract the investment risk of the Growth Assets to an acceptable level. They also provide *diversification* benefits.

Efficient portfolios – risk, return and diversification

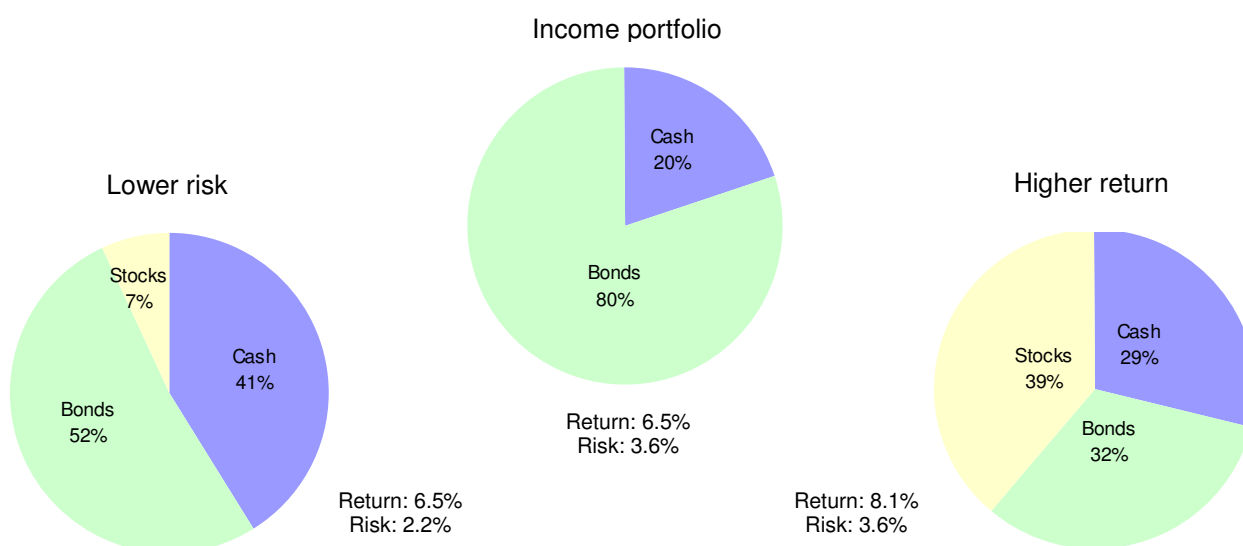
The pay-off between risk and return is the central relationship behind most investment decisions. However, many investment professionals try to imply that you can have the high returns without the risk. In reality the products recommended by these "professionals" either hide the risk (such as With Profits funds) or are unlikely to provide the implied returns (such as Guaranteed Equity bonds).

In contrast, for properly diversified portfolios the relationship between risk and reward is strong enough to achieve a successful investment experience, because we are able to capture virtually all the information we need to know about an asset in three numbers.

- **Return:** The expected return of an asset is described by the average annual growth rate as a percentage.
- **Risk:** Investment risk is described using a mathematical term called standard deviation, expressed as a percentage. All you need to know is that the higher the number, the more risky the asset.
- **Diversification:** The way one asset interacts with another is described by another mathematical function called correlation. It is the mathematical effect of not putting all your eggs in one basket.

The art of asset allocation is to blend different assets with different expected returns (rates of growth), risks (standard deviations) and diversification effects (correlations) so that combined portfolio will have either a lower risk for the same return, or a higher return for the same risk.

For each level of risk (or return) there will be an optimal mix of assets, called an “efficient portfolio”. Some of the results can be counter-intuitive. The chart below shows how adding UK equities to less volatile UK interest earning assets (the Income portfolio pie chart) between February 1999 and April 2008 could have been used to either reduce risk without sacrificing returns (Lower risk pie chart) or alternatively, to increase return without additional risk (Higher return pie chart).



Source: DFA Returns Program.

Hershey or Nestlé? – The two approaches to asset allocation

The variables of risk and return drive the two main methods of determining asset allocation. Whilst it is a sweeping generalisation, it’s convenient to label the two approaches as the American or Swiss way.

The American way is to determine the rate of return required from an investment and then design an efficient portfolio to achieve the required return. The client must accept the associated risk.

The Swiss way is to determine the level of risk acceptable to the client and then design an efficient portfolio to provide the highest return possible. The client must accept that the expected rate of return may not allow them to meet their financial goals.

It’s your money. You will have to live with the volatility associated with any investment strategy; therefore PageRussell adopt the Swiss approach. Comfort comes at a price. You may have to do one or more of the following: adapt your goals; save more; or accept more risk. Having a financial plan makes it possible to work out which combination of strategies is best for you.

Further diversification with other assets

Having chosen your top level asset allocation mix of Growth and Defensive assets, it is then time to add small portions of other assets to make your portfolio even more efficient.

- **Small and value companies**

The value of shares in both small companies and “value” (or unpopular) companies behave so differently from the whole stock market that they can be considered separate asset classes. These two classes on their own have higher expected returns and risk than the stock market as a whole. But, because of the way these two asset classes interact, adding a modest amount of small and value companies to portfolio increases the return, without increasing the risk. These small and value effects are also found in international and emerging markets.

- **International**

Not only do overseas equity and fixed income market prices move differently, the change in the value of the Pound Sterling to other currencies also acts as an extra diversifier. So adding international equities and fixed interest assets to a UK-based portfolio makes it more efficient.

- **Emerging markets**

Investing in emerging market equities can also increase the return of the portfolio without increasing overall portfolio volatility, because of the low correlation with other equities. To reduce the risk of investing in this risky asset class, we only invest in countries with: a stable political environment; a well organised financial market; a market with ample *liquidity* for shares; and a stable legal system that protects property rights and upholds contractual obligations.

Asset class investing

Now you have chosen a detailed asset allocation, you need to decide how you will capture the returns from those assets in practice, as accurately and cost efficiently as possible.

The solution is to use institutional asset class funds. Originally, the minimum investment for these funds was millions of pounds for each asset class, making them available only to the wealthiest investors. Fortunately these institutional asset class funds are now available to PageRussell clients. The benefits of access to these institutional asset class funds are:

- **Lower operating expenses**

All investment funds have expenses that include costs such as management fees, administrator charges and custody fees. The average annual expense ratio for retail equity unit trusts in the UK is 1.8%, compared with 0.5% for institutional asset class funds. All other factors being equal, lower costs mean higher rates of return.

- **Lower turnover resulting in lower cost**

Most active investment managers do a lot of trading, believing this adds value. High turnover is costly to investors because each trade incurs stamp duty, commissions, spreads (between the bid and offer prices) and market impact costs. These hidden costs can be more than a fund’s total operating expenses if the fund trades heavily. Institutional funds often have significantly lower turnover because they are designed to deliver a specific asset class return with at low a cost.

- **Consistently maintained asset class exposures**

There is no point in carefully working out a detailed asset allocation with a risk level appropriate to you; only to relinquish control to an active fund manager who invests your money in investments with different risks in pursuit of the latest ‘hot’ stock or sector. Institutional asset class funds do not have this problem because their mandates require them to stay fully invested in the specific asset class they represent.

How thinking of boiled sweets can put tax in its place

We have not mentioned investment contracts such as *ISAs* or pension so far in this guide.

An investment can be thought of as having two parts: the **tax wrapper** and the **underlying investment**. The tax wrapper determines how the underlying investments are treated by HM Revenue & Customs. An ISA is an example of a tax wrapper.

It may help you to think of a boiled sweet which also comes in two parts:

- The sweet wrapper, which keeps the sweet fresh, is like the tax wrapper which keeps your underlying investment fresh by reducing the tax paid.
- The sweet inside, which comes in different flavours, is just like the underlying investment, which comes in different asset allocations.

Tax is not as important as getting the right asset allocation or having low investment costs. Investment administration systems are now available that make organising your investments in a tax-efficient manner a mere formality.

Rebalancing - keeping emotions in check

Evolution has left humans poorly wired for investing. Our emotions are powerful forces that cause investors to buy high and sell low, which is exactly the opposite of what we should do. If this is repeated over a long period of time, it will cause serious damage to your investments and more importantly your financial dreams.

Here is an example to show how this can happen:

If you are like most investors, you don't buy the share right away; you follow it for a while to see how it does. If the share price starts to rise you watch it for a bit longer. You start to feel hopeful that this might be the one investment that helps you make a lot of money. If the price continues to rise a new emotion takes over: it is greed. You decide to buy the share that day.

You know what happens next... Soon after you buy it the share price starts to go down and you start to feel regret and possibly fear. You are afraid you've made a terrible mistake. You promise yourself that, if the share goes back up to where you bought it, you will never buy like this again. You don't want to have to tell anyone about the loss. You don't care about making money anymore.

If the share price continues to go down, another emotion may kick in: panic. You sell the share just to stop the emotional pain that seeing it go down in value is causing you. Then what happens? New information comes out and the share price races to an all time high.

To overcome this risk, PageRussell periodically rebalances our clients' portfolios back to the target asset allocation. By rebalancing whenever your portfolio strays too far away from your target asset allocation, we are enforcing a systematic 'buy low, sell high' discipline which enhances the long-term return for the portfolio.

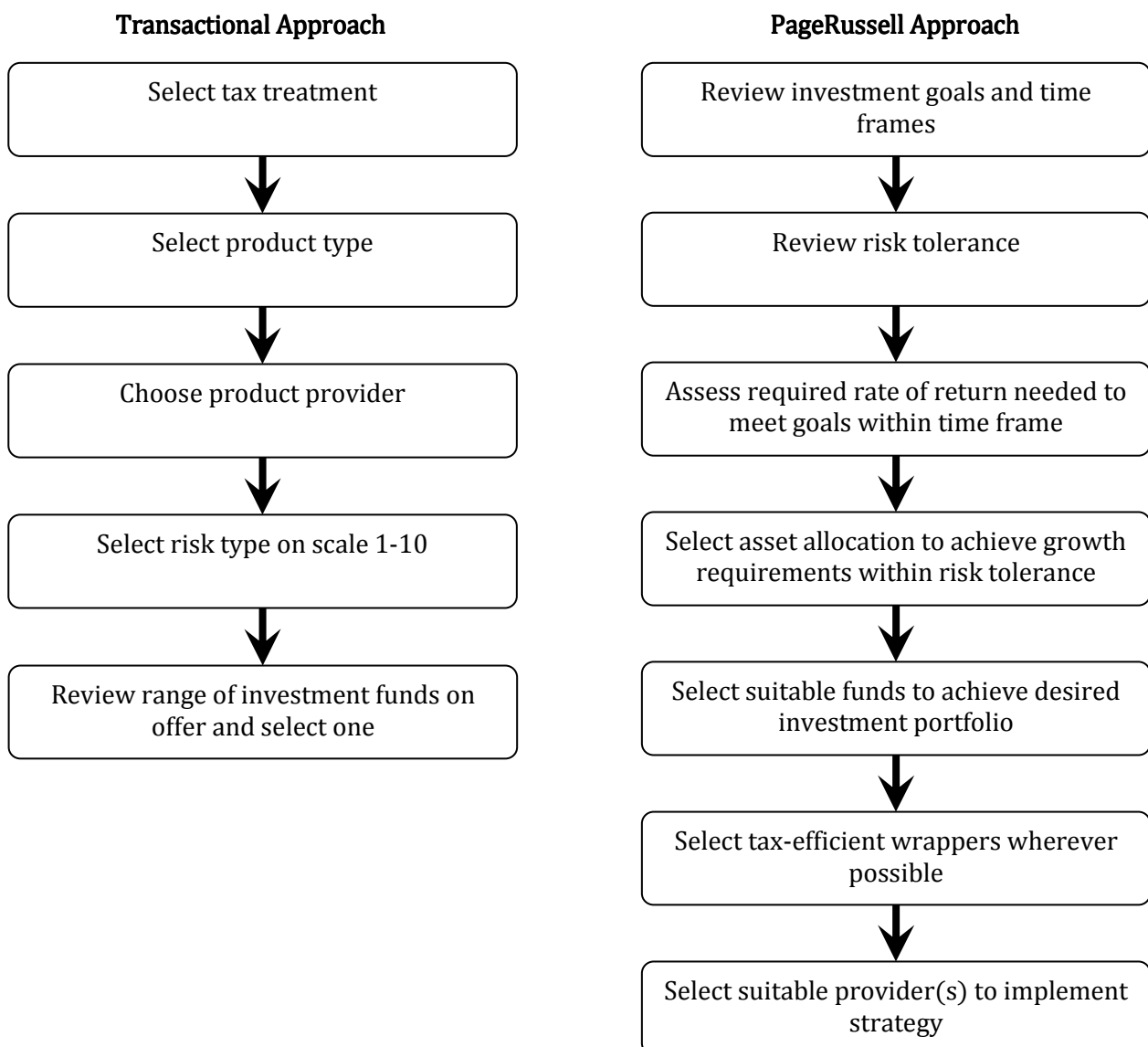
Without rebalancing, portfolios tend to become more volatile over time as the Growth Assets grow faster than the Defensive Assets. After a few years without rebalancing, your portfolio will become more risky than you are comfortable with.

Your next steps

We live in a time of volatile investment markets. One of the best things you can do as an investor is to ensure that your financial plan is current. Your plan should examine where you are now and where you need to go to realize your financial goals, and should also identify the gaps in your plan.

Like all professional services all you need to do this for yourself is the time, inclination and expertise. Today the expertise is just a few clicks away. However, most of us are not wired emotionally to develop and maintain our own investment plan effectively. You may want to consider working with a qualified financial adviser.

If you do choose to work with a financial adviser, you should be aware that not all advisers will approach your investments in the same way. There are two types of advisers: those who are transactional and those who are consultative. What is the difference? Transactional advice is primarily focused on recommending a variety of investment products to their clients. Consultative advisers, like PageRussell, on the other hand, are primarily concerned with offering their clients a consultative approach that will help them meet their clients' investment goals. The practical differences between the two approaches are best shown in these flow charts:



You can see that not only is Transactional approach less thorough; it looks at the most important decision (asset allocation) last and the least important (tax wrapper) first.

About PageRussell

We help individuals, business owners and trustees from East Anglia and London to implement smart solutions so they have enough money to live the life they want.

We charge fees. This means we can concentrate on recommending the right solution for you. If a product is needed, we are independent and advise on investments and insurance from the whole market.

No surprises

Before you sign up to one of our services, we will tell you what our charges will be and how long the work will take.

Long-term

As a two-generation family business, we understand the importance of long-term relationships and have set up our business to provide a service to match.

Our advisers



Richard Page

CERTIFIED FINANCIAL PLANNER^{CM} professional

Richard is the founding director of our firm. He has advised business owners on their financial planning since 1986. An early advocate of professional qualifications in financial services; Richard never rests on his laurels. He became a CFP Professional in 2007 and in 2009 won the award for Pre-Retirement Planning at the Money Management Financial Planner Awards. Richard has been married to Eileen for over 40 years.



Stephen Page

CERTIFIED FINANCIAL PLANNER^{CM} professional

Stephen joined the business in 1997 and is now a director. Stephen has particular skills in cash flow modelling and investment consolidation. Stephen is a CFP Professional and an active member of the Institute of Financial Planning. Son of Richard and brother of Tim, Stephen and his wife Alison have a daughter, Phoebe.



Tim Page

CERTIFIED FINANCIAL PLANNER^{CM} professional & Chartered Financial Planner

Tim joined the firm in 1999 and is now a director. Tim is a Chartered Financial Planner, a CFP Professional and holds the CFA UK Investment Management Certificate. In 2003 and 2004 Tim was a member of the winning team in the Institute of Financial Planning's Team Challenge. Tim was Chairman of the Institute of Financial Planning's East Anglia branch in 2007 and 2008 and has been a CFP case study assessor. Son of Richard and brother of Stephen, Tim and his wife Annie have a daughter, Rosie and a son, Eddie.

Where can I find out more about investing?

Call us on 0845 345 6282, e-mail tim@pagerussell.co.uk or go to www.pagerussell.co.uk.

Our clients can also view our detailed **Investment Philosophy** document.

Also, we find www.indexinvestor.com a mine of useful information.

Jargon Buster

This section explains what PageRussell means by the following terms:

Asset allocation	The mix of investment asset classes used to make up your portfolio.
Asset class	A broad type of investment (such as UK company shares) whose risk and expected return are similar. Each asset class is a unique and separate source of return and risk for investors. It is important to emphasise this means the whole market (such as FTSE All Shares index) rather than an individual investments (such as BT), or sector (Telecoms).
Diversification	A technique used to lower the total risk of loss in your investment portfolio by investing it in a range of different underlying investments. In other words, not putting all your eggs in one basket.
Equities	Publicly traded shares in companies. You own a small part of the company. Equities are a Growth Asset : taken collectively as an asset class they can be expected to grow faster than inflation over the long term. In return you can expect to have shorter periods where their values fall.
Fixed-interest (securities)	Publicly traded debt (often called bonds), normally issued by governments and large companies. You own the debt owed by the government or large company. Fixed-Interest is a Defensive Asset , the returns are lower than Growth Assets but so is the investment risk. Fixed-Interest investments are added to portfolios to counteract the investment risk of the Growth Assets to a level acceptable to the investor. They also provide diversification benefits.
Individual savings account (ISA)	A tax-efficient savings and investment contract: <ul style="list-style-type: none">• Stocks & Shares ISAs: long-term investment.• Cash ISAs: short-term savings.
Investment	A well diversified group of securities where you expect to see a defined relationship between the investment risk taken and the reward you expect to receive over the long-term. If this relationship does not exist then PageRussell considers it to be a speculation, not an investment.
Investment risk	The short-term volatility (up and down movements) of investment values. Also means the possibility of losing some of the original amount invested when you come to sell; or the possibility that you fail to meet your goals.
Liquidity	The speed and ease with which an investment asset can be bought or sold.
Savings	Money used to fund your short-term needs (5 years or less). Usually held as cash deposits with a bank. Cash is safe and available when you need the money. Inflation reduces the real value of savings over the long-term.
Securities	The individual underlying investments held in your investment portfolio such as shares in a public company or UK government bonds.
Speculation	An “investment” with no long-term relationship between the investment risk taken and the expected reward. PageRussell believe it’s OK to speculate - as long as you know you are doing so and are financially able to bear a 100% loss. Many unwitting speculators think they are investing.
Tax wrapper	The tax wrapper determines how the underlying investments are treated by HM Revenue & Customs. ISAs and pensions are different examples.