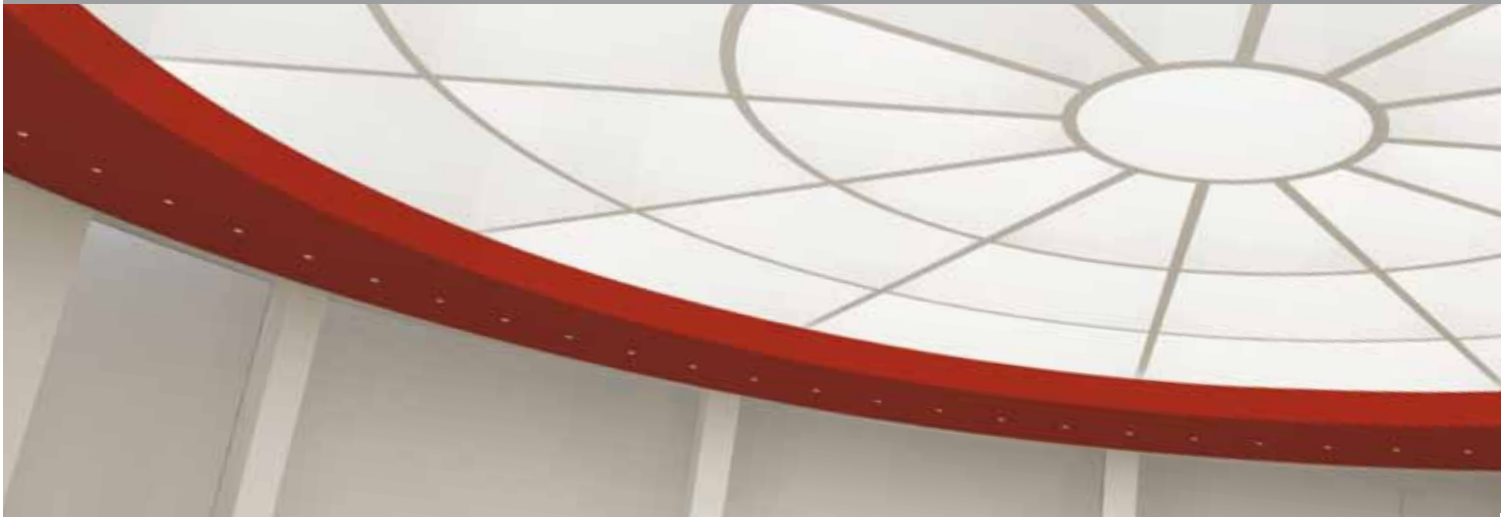




# Core-satellite investing

## A powerful investment strategy



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This guide explains core-satellite investing and why you may want to consider this approach when working with your financial adviser to construct and manage your investment portfolio.

As the term suggests, core-satellite investing separates a portfolio of investments into two distinct segments: core and satellite. It means having a core of long-term investments, with other, perhaps more specialist or shorter-term satellite investments.

This guide takes you through the key principles and techniques of the approach, including:

- 1** The power of core-satellite investing.
- 2** Blending different investment styles.
- 3** The advantages of index funds at the core.
- 4** Using active and sector-specific index funds as satellites.
- 5** Implementing a core-satellite portfolio.

From reading this guide you will gain an understanding of how to work with your financial adviser to construct an investment portfolio using a core-satellite model.

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- 3** The power of core-satellite investing
  - 4** Building on the importance of asset allocation
  - 6** The roles of index and active management
  - 8** Indexing at the core
  - 10** Active or specialist index funds as satellites
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# The power of core-satellite investing

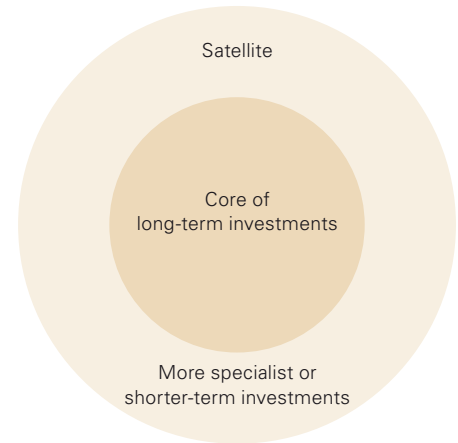
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Core-satellite investing is a proven investment strategy that applies rigorous academic research in a real-world application. At its most basic level it comprises a core of long-term investments with a periphery of more specialist or shorter-term investments.

## A common sense approach

Constructing an investment portfolio with a stable core of long-term investments and a periphery of more specialist or shorter-term holdings can:

- Spread risk between a greater number of holdings.
- Enable you to benefit from a variety of investment strategies.
- Decrease the degree to which a portfolio experiences market ups and downs.
- Reduce costs.
- Offer the potential to outperform the market.
- Reduce the need for periodic, potentially expensive portfolio adjustments.



The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

# Building on the importance of asset allocation

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Core-satellite investing rests on a solid foundation of academic research and theory on how to construct an effective investment portfolio.

## Building on the benefits of asset allocation

The approach builds upon the concept of asset allocation. Asset allocation simply means investing in a broad variety of asset classes in order to meet your overall investment objectives. The advantages of asset allocation come when you combine different investments that tend not to go up or down in value together which can help smooth out the investment returns of an investment portfolio.

Academic research has consistently shown that over the long term, asset allocation determines the greatest part of a portfolio's investment outcome. Picking individual assets or trying to time the market – in other words, trying to enter it at the bottom and sell at the top – have only minor influences, especially over the long term.

## What's in the core and satellite?

In a traditional core-satellite structure, core investments tend to include long-term low-cost investments. A selection of index funds which deliver the returns of an index such as the FTSE All-Share may provide meaningful core investment solutions. Satellite investments sometimes include more specialist investments that are not highly correlated with core investments.

The core and satellite, working together, help to deliver the benefits of asset allocation and the potential to outperform any one market.

### **Asset classes**

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

### **Index**

An index is a collection of equities or bonds chosen to represent a particular part of the market, such as the FTSE All-Share.

### **Index fund**

An investment fund which aims to closely match the returns of a specified market index. A change in the price of an index should produce an almost identical change in the index fund.

### **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.

# The roles of index and active management

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Core-satellite investing allows you to combine two complementary approaches to investment management in the same portfolio: the index approach and the active approach.

## The index approach

Index managers aim to produce the same returns as the index they track. Index funds achieve this by investing in the same securities as a given index, or a representative sample of it, in order to track its overall performance. An index fund does not require the research and analysis that active management requires, which reduces costs considerably. In addition, index funds tend to hold investments for long periods of time, rather than trading frequently. This helps to control costs in the fund and ultimately for investors.

## The active approach

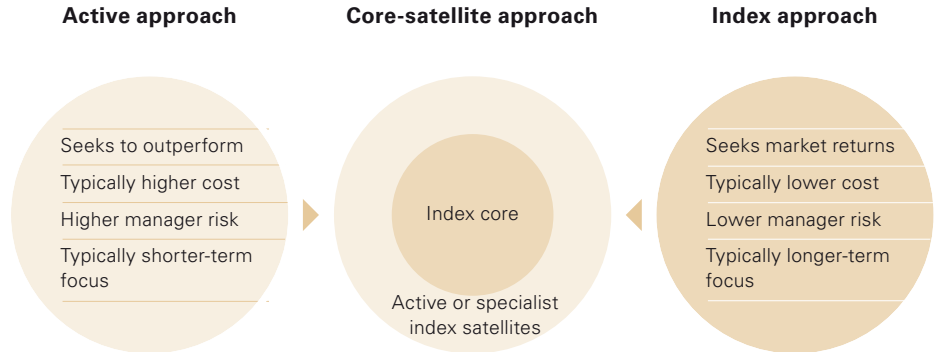
Active managers aim to outperform the market by using their knowledge and skill to analyse the market, and investing in securities which they believe have potential to deliver superior investment returns over time. Active managers can also adjust their portfolios to minimise potential losses. For example, they can avoid individual assets, industries or countries which they believe may underperform over a certain period.



## Combining both in one portfolio

Core-satellite aims to deliver the best of both worlds. Using index funds as the 'core' of your portfolio may provide an effective, diversified, lower-cost foundation for an investment portfolio. Using carefully selected actively managed satellite funds, or specialist index funds can complement the core and give the potential for higher investment returns.

The relative sizes of the core and satellite in your portfolio will depend on your investment objectives, individual circumstances and risk profile. This is where your financial adviser can help.



# Indexing at the core

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Having discussed how core-satellite investing can include the best of active and index management, it's worth having a closer look at the advantages of having index funds at the core of your portfolio.

## Low costs

Index funds charge investors lower fees than most active funds investing in similar assets. That's because it generally costs less to administer and operate an index fund than an actively managed fund. Index funds also tend to trade less than most actively managed funds, resulting in lower ongoing trading costs. In addition, they require less analysis and research to implement, which also helps keep costs low.

## Greater portfolio diversification

Most index funds invest in a wide selection of securities, which reduces stock-specific risk. As a result, an index fund is less exposed to the fluctuations of individual equities, which can reduce portfolio volatility and smooth investment returns. However, index funds track the entire market: so when the overall stock market (or bond prices) fall, so do index funds.

## Reduce key person risk

By not being dependent on the skills of individual fund managers, investors avoid exposure to the risk of that person no longer managing a fund.

## Simplicity

An index fund offers an easy way to invest in a chosen market as it simply seeks to track an index. There is no need to select and monitor individual managers or choose between investment themes.

# Active or specialist index funds as satellites

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The satellite provides an opportunity to supplement the core with actively managed or specialist index funds.

## Actively managed funds

### **The opportunity for outperformance**

Fund managers who use an active investment approach aim to either outperform the market average by beating a selected index of shares (such as the FTSE All-Share) or bonds, or by achieving a specific investment objective.

They seek to do this by using their knowledge and skill to analyse the market. Then they buy shares or bonds which they believe have the potential to rise in price or increase their dividends over time.

### **Defensive measures**

Managers can also adjust their portfolios to attempt to minimise potential losses. For example, they can avoid individual shares or bonds, sectors, industries, or even countries which they believe may underperform over a certain period.

### **Choice**

Active funds come in a wide range of specialist styles, markets, sectors and geographies, offering infinite choice for diversification.

## Specialist index funds

Some specialist index funds can also play a part as satellites. In addition to the more typical index funds which track major indices such as the FTSE All-Share, some investment firms offer funds that track specialist markets, industries or sectors. Examples of sectors or industries include mining, oil and gas, pharmaceuticals and retailers. Specialist markets might include emerging markets such as the fast growing economies of the BRIC (Brazil, Russia, India, China) or geography-specific funds, such as Europe or Asia. By holding investments across different sectors you can protect yourself against the risks of one or more sectors underperforming.

## Your adviser can help

In the case of both actively managed or specialist index funds, your adviser can help you find those funds that are appropriate for you and your portfolio.

# Implementing a core-satellite portfolio

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Core-satellite portfolios can be as cautious or as adventurous in their approach as any other portfolio. The mix of investments you choose will depend on your individual investment objectives. Your adviser can help you set your objectives and walk you through this process.

Investors, with their advisers to guide them, should consider the following points when deciding on their investment strategy.

## 1. Determine asset allocation

Understanding your attitude to risk is one of the first steps in using the core-satellite model. Your financial adviser can help you work through understanding your goals, personal circumstances, preferences and tolerance for risk. Once these have been established, it's then possible to determine the most appropriate asset mix, which will often be a combination of the four main asset classes – equities, property, bonds or cash.

## 2. Allocate between core and satellite

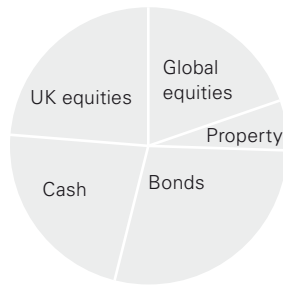
You then need to decide what proportion of each asset class should be allocated to core index funds and what proportion allocated to satellite actively managed or specialist index funds. Ultimately, the balance between index funds will be governed by the degree of risk you are prepared to accept.

### 3. Select index and active managers

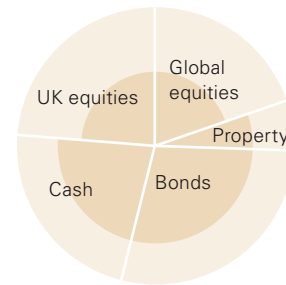
Lastly, you need to select the index and active funds for both core and satellite.

Through all three steps of implementing a core-satellite investment strategy you should seek the guidance of a financial adviser.

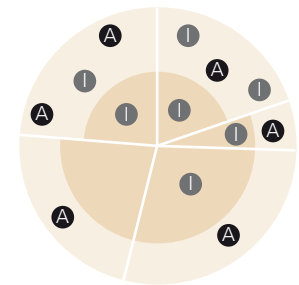
#### 1. Determine asset allocation



#### 2. Allocate core and satellite proportions



#### 3. Select index and active funds



- Active and specialist index investments (satellites)
- Index investments (core)

- I Index
- A Active

Note:

The asset allocations in this diagram are intended to be an example only and not a recommendation.

# What next?

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The guide has given you a broad introduction to an investment approach that is used by professional and private investors alike.

We've explored how constructing an investment portfolio with a stable core of long-term investments and a periphery of more specialist or shorter-term holdings can:

- Spread risk between a greater number of holdings.
- Enable you to benefit from a variety of investment strategies.
- Decrease the degree to which a portfolio experiences market ups and downs.
- Reduce costs.

- Offer the potential to outperform the market.
- Reduce the need for periodic, potentially expensive portfolio adjustments.

With this knowledge, you should be more prepared to work with your financial adviser to decide what proportion of assets you should have in core and satellite funds, bearing in mind your risk tolerance and investment goals, in order to arrive at a portfolio that is appropriate for you.











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