Portfolio construction

A systematic approach to investing

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This guide is about portfolio construction, the process of organising your investments as a whole, rather than piecemeal.

It explores the key principles and techniques behind effective portfolio construction, so that you have the best chance of constructing a portfolio that meets your investment objectives.

It takes you through:

1. Allocating your money between the major types of investment
2. Deciding between actively managed and index funds or a combination of both
3. Selecting between different individual funds and fund managers.

This guide will introduce you to the basics of constructing a professional portfolio and choosing funds and fund managers. This understanding will help you to work with your financial adviser to construct a portfolio with the best chance of meeting your investment objectives.

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The importance of portfolio construction

Planning your investments with a financial adviser, rather than taking an ad hoc approach, has the potential to help you more closely reach your investment objectives.

When it comes to building a portfolio, some individual investors focus on selecting the right fund manager or security. However, manager selection forms only a small part of the process. At a broader level, portfolio construction should be about structuring your portfolio in a way that stands the best chance of meeting your stated investment aims within your acceptable level of risk.

Professional and private investors often set about building investment portfolios in different ways. The simplest way to describe these approaches is bottom-up and top-down.

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

Fund (or pooled fund)
An investment vehicle in which investors combine their money in a pool, which then invests in a range of securities. Each investor shares proportionally in the fund's investment returns.

Bottom-up investing

Bottom-up investing, often used by individual private investors, typically starts by choosing a manager or fund they like, only subsequently, if ever, considering how to construct the portfolio as a whole. This ad hoc approach takes no account of the investor's objective or risk profile. In addition, studies of investor behaviour show that individual investors often chase top-performing investments or funds, by which time the performance has already been delivered, which leads many to lose money by buying at the top and selling at a loss.

Top-down investing

By comparison, professional investors begin by exploring investment risk and what they need the investment to do for them. They then work through a series of steps, creating a framework to decide which types of investments are needed. Only then do they choose individual funds or other investments. Planning a portfolio based on risk tolerance and investment objectives gives you a better chance of meeting your goals within a level of risk you are comfortable with.

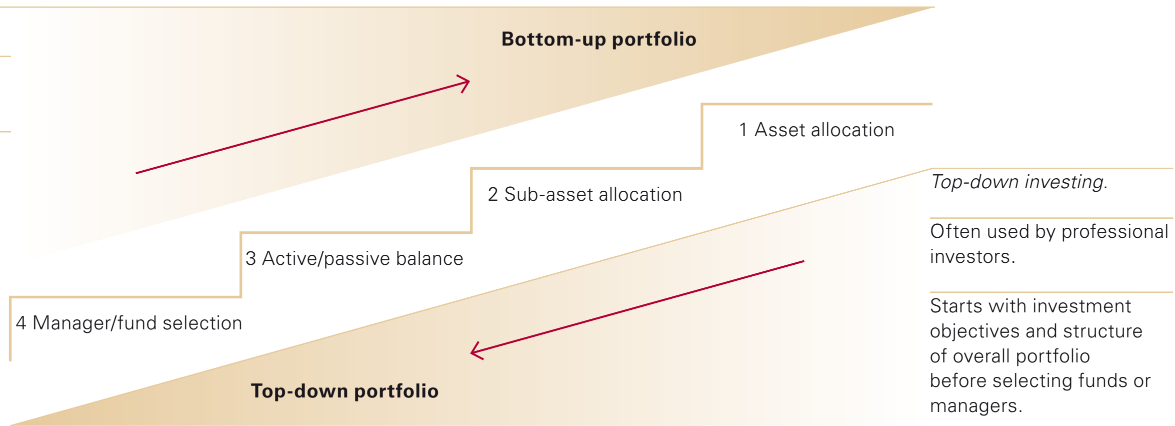
At a very general and simplified level, the top-down approach generally goes through four broad stages:

1. Decide how to allocate your money between the different types of investments (asset allocation).
2. Choose where to invest within each investment type.
3. Decide on the balance between actively managed and index passive funds.
4. Evaluate individual funds and fund managers.

Bottom-up investing.

Often used by private investors.

Builds portfolio by piecemeal, ad hoc selection of fund manager or product.



Stage 1: Asset allocation

Several studies have shown that the most important decision when constructing a portfolio is asset allocation. This means making sure your portfolio has the right mix of assets to suit your individual circumstances, investment aims and attitude to risk.

A word about risk

As a key part of the process of constructing a portfolio, you need to consider your attitude to risk. All investments entail different levels and types of risk. Your adviser can help determine your risk tolerance.

Then you can work together to decide an asset allocation that offers you the best chance of achieving your investment objective within your level of risk tolerance.

Diversification can reduce risk

In order to reduce your risk, you need to diversify – that is, spread your portfolio across a broad mix of assets.

Investment markets move in different cycles, reflecting the underlying strength of the economy, industry trends and investor sentiment. Individual assets also move differently according to external factors. So for example, during hard economic times many people will stop buying luxury items and companies that make them might experience a fall in sales, but makers of essential items, like food, may not.

Diversifying your portfolio can help smooth out market ups and downs: so returns from better performing assets help to offset those that aren’t performing so well.

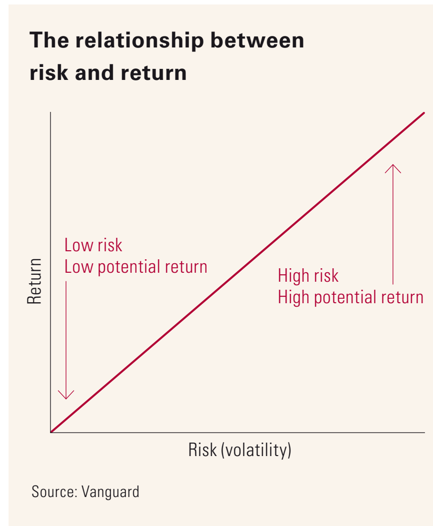
Diversification
Spreading your money across a range of investments to help protect against or lessen the impact of sudden falls in any particular market or individual investment.

Investment risk
The chance that an investment’s actual return will differ from expectations.

Balancing risk and return

The concept of risk/return suggests that low levels of investment risk will result in potentially lower returns, while high levels of risk will generate potentially higher returns. Of course, there are no guarantees. While increased risk offers the possibility of higher returns, it also can lead to bigger losses. Your adviser can help you construct a portfolio with the potential to give you the best possible returns for a given level of risk.

The relationship between risk and return



Source: Vanguard

Avoid dangerous fads

Using an asset allocation strategy helps free you from the risk of following dangerous investment fads. Even professional investors sometimes get their timing wrong, following the herd into a hot asset or market that has reached its top and may fall dramatically. Having a formal strategy can help by ensuring that your portfolio stays balanced.

Select uncorrelated assets

For effective asset allocation, professional investors often seek to combine assets that tend to do well at different times. A simple everyday example might be how sunscreen will sometimes get discounted during a cold summer, while coats and jackets might be marked up. At a simple level, these two items could be said to be uncorrelated.

Talk to your adviser about the risk and correlations associated with different assets.

Start now

Ideally, you would start constructing a portfolio with a blank sheet of paper (and a pile of cash to invest). In practice, many people already have a spread of investment assets before they begin a structured investment plan.

Your adviser can help

By helping you determine your ideal asset allocation, your adviser can work with you to re-shape your investments over time so that you have the best chance of meeting your investment objectives.

Correlation
A statistical measure of the degree to which the movements of different asset classes are related.

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).

Stage 2: Sub-asset allocation

Once you've decided on your overall asset allocation, you need to decide on sub-asset allocation – that is, how you divide your money between the sub-assets, or different kinds of asset within each asset class.

You have a few things you may want to consider before deciding on a sub-asset allocation.

Sub-asset class types

Each asset class comprises of a broad variety of sub-asset classes. For example, a sub-asset class within equities might include: large companies, smaller companies, growth funds, income funds and global equities.

Investment style

Fund managers tend to follow investment styles which perform differently depending on the market or economic environment. These styles can be identified and categorised, at least in broad terms. We will consider investment style in greater detail later in this guide.

Diversification across sub-asset classes and investment styles

Just as when you combine the major asset classes, diversification is essential when choosing sub-assets. It helps to ensure that you don't take on too much risk by concentrating in a particular sub-asset class.

In some cases, you may decide to adjust the proportions of sub-classes you hold perhaps to increase your portfolio's potential for growth (while tolerating an extra degree of risk).

Understanding of the various sub assets, along with the different investment styles that can apply within the sub-asset classes, can help you to work effectively with your financial adviser to construct a well-diversified investment strategy.

The following sections introduce these topics in greater detail and discuss the roles that different sub-asset classes can play within your portfolio.

The main sub-asset classes

Equities		Bonds	
Sub-asset class	**Description**	**Sub-asset class**	**Description**
Equity growth	Company shares that are believed to have the potential to increase in value faster than those of the general market. These companies will often be relatively young, and so could be expected to increase their turnover and profits substantially.	Gilts (UK government bonds) – Fixed interest – Inflation linked	UK gilts are loans made to the UK government in return for regular interest payments. They are considered to be low risk investments. Fixed interest gilts always pay a fixed amount of income, while inflation-linked gilts will vary depending on the official rate of inflation.
Equity income	Companies that generate a higher-than-average income, such as utilities.	Corporate bonds – Investment grade – High yield	Corporate bonds are loans made to private companies or organisations and range from fairly reliable investment-grade bonds to highly risky high-yield bonds.
Larger companies (sometimes called 'blue chips' or 'large-cap')	UK large company stocks are generally considered to be the largest 100 stocks by market value, such as those listed on the FTSE 100 stock index.	Global bonds	Global bonds can be from foreign governments or corporations and vary widely in both risk and return characteristics.
Smaller companies	UK smaller companies are exactly that, the small companies listed on a stock exchange, often considered to be the companies that are smaller than the top 350 largest companies.	Long-term bonds	Long-term bonds usually have many years to run, from three up to even 50 years. They tend to pay a higher rate of interest than short-term bonds.
International equities	Non-UK or international equities can include funds that invest across the globe, or specialist funds which invest in a specific region, country or theme. Examples include Japanese equity funds or BRIC funds (Brazil, Russia, India, China).	Short-term bonds	Short-term bonds typically have less than three years to run before they mature.

Equities – Income or growth?

Traditionally, there are two high-level types of equity funds:

A **growth fund** aims to provide capital growth by investing in company shares that the manager believes have the potential to increase in value faster than those of the general market. These companies will often be relatively young, and so could be expected to increase their turnover and profits substantially.

An **income fund,** by contrast, focuses on providing a relatively high regular income rather than capital growth. Income funds will tend to invest in companies that generate a higher-than-average and fairly reliable income, such as utilities.

Your risk profile, investment timeframe and need for income, will help determine the balance of growth and income funds within the equity part of your portfolio.

Equities – investing by size

Large company stocks can sometimes be less volatile than smaller companies and therefore are perceived to entail less risk. Large and small company stocks also tend to perform very differently depending on the economic environment, making them good diversifiers within a well-constructed portfolio. But always remember that past performance is not a reliable indicator of future results and these historical trends may not always hold true.

Equities – investing overseas

Adding international equities to your equity portfolio can help spread the risk of being invested in just one stock market. Investors can significantly reduce the volatility inherent in holding just one stock market by allocating some of the equities portion of their portfolio into overseas equities.

Volatility
The extent to which asset prices or interest rates fluctuate over time. Volatility is often used to assess the potential risk associated with an investment.

Bonds – key considerations

A bond is a loan issued for a set time period. For example, a ten-year bond will run for ten years from its issue date. You may include bonds in your portfolio to help offset some of the volatility of equities, since bond and equity prices may move in opposite directions. But even when they don’t, movements in bond prices tend to be less volatile than those of equities. And the regular interest payments that bonds generate can be reassuring when equity prices fall.

Bonds come in a variety of types, quality and time periods. When putting together a portfolio that includes bond funds you need consider the various types available.

Bonds – government and corporate

UK Government bonds (gilts) offer a higher degree of security, as they are backed by the British government. They’re generally considered to be low risk and pay a relatively low rate of interest. Government bonds are offered in a straightforward fixed payment form, or specialist bonds designed to protect holders against inflation by adjusting the value of the bond in line with an official measure of inflation.

Corporate bonds are issued by companies and tend to offer higher interest rates because they are considered to be more risky than governments bonds.

The bonds of larger, more stable companies are classed as ‘investment grade bonds’ and are rated as having a higher degree of security.

High-yield bonds on the other hand, are issued by companies judged to have less credit worthiness. These bonds tend to pay a higher interest rate to compensate investors for the potentially higher risk of default, which means that there is more chance the holder could lose their entire investment.

Bonds – time to maturity

Long duration bonds tend to pay a higher income than short-term bonds, especially during periods of relative economic stability, but their price will also fluctuate more. This is because interest rates may change radically over the long term, which affects bond prices. So a typical long-term investor may aim to combine long-term and short-term bonds – balancing high income against the comfort of price stability.

Fixed interest investments
As bonds typically offer regular payments of a fixed amount of interest, they are sometimes called fixed interest investments.

Maturity
The set point in time when a bond issuer pays back the capital.

Duration
The amount of time left on a bond before its issuer pays back the capital.

Active management
Fund managers who use an active investment approach aim to either outperform the market average by beating a selected benchmark or index or bonds, or by achieving a specific investment objective.

Passive (index) management
An investment style which aims to closely match the returns of a specified market index.

Investment style

One of the ways investment funds differ is in their style. Of course, index funds simply seek to reflect the performance of an index, as we'll see later. But actively managed funds often adopt a specific style, which they hope will result in greater gains than those of an index or other benchmark.

Investment style refers to the approach the manager takes, such as growth, value or a blend of both. Style generally applies to equities, but can also refer to certain types of bond funds.

Different investment styles may work better at different times. So, when you're putting together your portfolio with your adviser, you may consider investing in a mix of styles. Mixing different investment styles together in a single portfolio also increases diversification in the same way as mixing asset classes. This helps reduce the risk that you are only exposed to a single investment style.

Style	**Description**
Growth	As the term implies, growth stocks are considered to be those with the greatest potential value to grow at a rate that is higher than the market average. Growth style managers look for companies which have exceptional potential to grow, and to increase their share price over the longer-term.
Value	Value stocks are those that are considered to be undervalued by the market relative to their earnings potential. Value style managers seek to buy companies whose shares are currently selling for less than their intrinsic value, or where they believe future earnings potential has been underestimated.
Blend	A blended approach to active management attempts to blend the best of the two styles.

Style and sub-asset type

There are fund managers with different investment styles operating within every asset and sub-asset class. So, for example, you could have a small companies specialist with a value investment style. Sometimes managers use a blended style, relying on a team with different style focuses in an effort to eliminate style bias altogether and try to get the best of both.

The graphic shows how this works using equities, with the different boxes representing different fund and style types.

Growth	Blend	Value
Small companies growth	Small companies blend	Small companies value
Large companies growth	Large companies blend	Large companies value

These types of style boxes help break down and analyse sub-asset classes so that when you work to construct a portfolio with your financial adviser, you will know what you are investing in and how each sub-asset class relates to others.

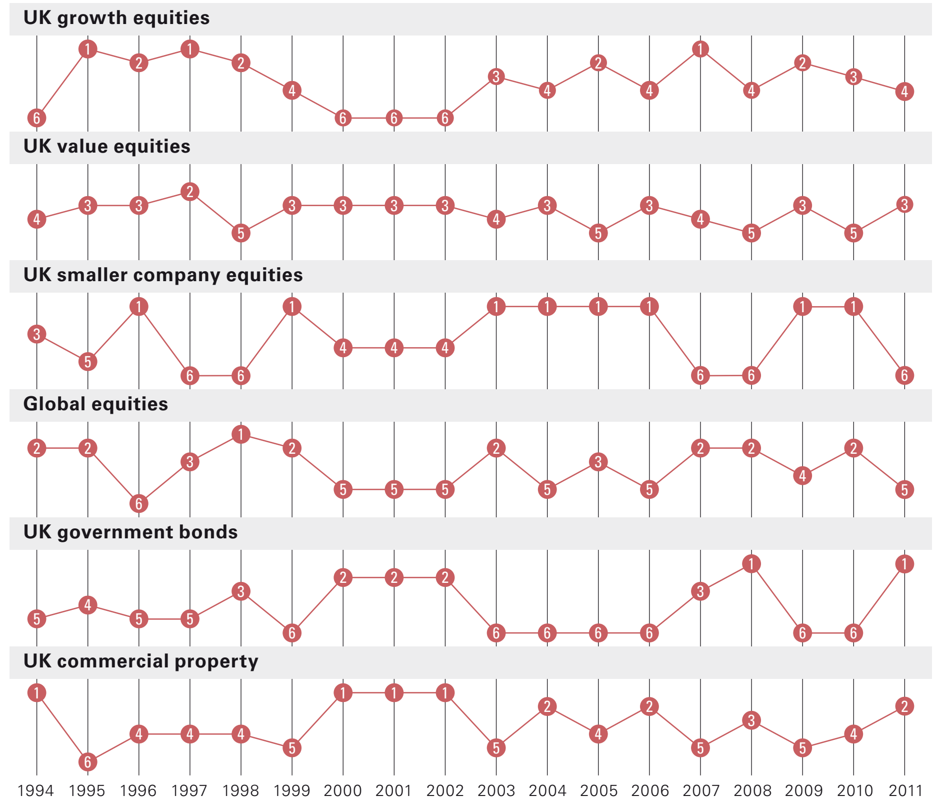
Sub-asset class performance over time

Depending on things like changes in the overall economy and even investment fashions, the best and worst performing asset and sub-asset classes continually change. For example, growth funds may perform well compared to income funds during economic booms and vice-versa when the economy is slower.

The chart gives puts this into context, showing how various equity sub-asset classes performed between 1994 (the first year that separate data for growth and value styles became available) and 2009. The numbers show their ranking from best (1) to worst (6) for each year since 1994.

This is why it's so necessary to diversify across different sub-asset classes. Since it's impossible to forecast which sub-asset class or classes will be next year's winners, it makes sense to hold a spread rather than try to pick the next big thing.

Annual performance rankings for selected asset classes



1 Relative annual performance ranking

Source: Thomson Reuters Datastream and Lipper Investment Management, discrete annual performance 31/12/1994-31/12/2011. Indices used: UK growth equities (FTSE Growth), UK value equities (FTSE Value), UK smaller company equities (Hoare Govett smaller companies - ex Inv Cos), Globalequities (MSCI World ex UK), UK Government bonds (FTSE A British government all stocks), UK commercial property (UK IPD Property).

Past performance is not a reliable indicator of future results.

Annual performance rankings for selected asset classes

	UK growth equities	UK value equities	UK smaller companies	Global equities	UK government bonds	UK commercial property
1994	-9.84	-3.20	-2.99	0.69	-6.27	15.26
1995	28.96	19.62	14.99	22.25	16.43	3.20
1996	16.37	15.86	19.12	2.17	7.30	9.35
1997	28.10	24.45	9.21	20.17	14.14	15.43
1998	21.28	11.01	-5.75	24.24	18.93	12.15
1999	19.03	19.90	56.18	30.93	-0.88	14.13
2000	-11.15	2.81	1.17	-6.25	8.75	10.51
2001	-23.61	-3.79	-13.02	-14.61	3.04	7.06
2002	-31.64	-12.53	-23.28	-27.74	9.25	10.45
2003	19.26	18.04	43.03	20.50	2.10	11.24
2004	7.32	16.18	20.67	6.98	6.60	18.89
2005	24.29	18.27	27.79	23.38	7.93	18.83
2006	14.65	14.99	28.01	4.78	0.70	18.12
2007	11.60	2.80	-8.33	7.87	5.27	-5.47
2008	-25.19	-31.28	-40.83	-16.08	12.81	-22.53
2009	32.84	22.88	60.73	15.30	-1.16	2.18
2010	15.16	8.68	28.49	16.27	7.20	14.49
2011	-4.15	-0.30	-9.13	-4.58	15.57	8.09

Source: Thomson Reuters Datastream and Lipper Investment Management, discrete annual performance 31/12/1994-31/12/2011. Indices used: UK growth equities (FTSE Growth), UK value equities (FTSE Value), UK smaller company equities (Hoare Govett smaller companies - ex Inv Cos), Global equities (MSCI World ex UK), UK Government bonds (FTSE A British government all stocks), UK commercial property (UK IPD Property).

Past performance is not a reliable indicator of future results.

Stage 3: Balance actively managed and index funds

You have a choice of including active, index or both types of fund within your portfolio.

Passive funds, often called index or tracker funds, don't try to pick individual securities. Instead, they aim to reflect the performance of the market. They work by attempting to closely track an index, such as the FTSE All-Share Index. Active funds employ managers to research and pick equities or bonds in an attempt to beat the relevant index or market average – though in practice, it is difficult to do over the long-term.

It's possible to select a range of uncorrelated active and index funds in an effort to reduce overall portfolio volatility.

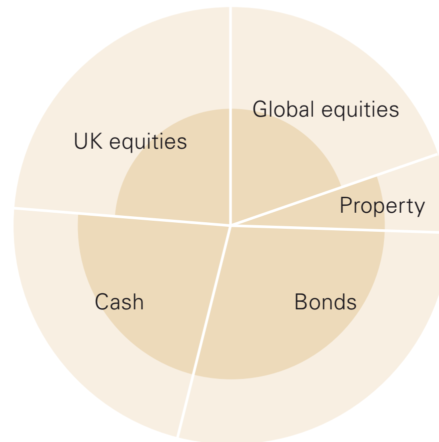
Combining active and index funds – the core-satellite model

In the core-satellite approach to portfolio construction, a large part of the portfolio (the core) is invested in index funds to capture the market return. Then, carefully selected active or specialist index investments (the satellites) are added to provide the potential for extra returns and diversification.

The chart shows how a portfolio could be constructed combining the advantages of both passive and actively managed funds. Please note that the asset allocation shown is for illustrative purposes only and is not a recommendation. Asset allocation should always be designed individually, to suit each investor's situation, needs and aims.

You need to work with your adviser to decide what proportion of assets you should have in core and satellite funds for each asset class. This will depend largely on your personal risk tolerance.

Allocate core and satellite proportions



Active and specialist index funds (satellites)
Index funds (core)

Stage 4: Choosing fund managers

Whichever kind of funds you want to invest in, you need to decide which fund manager or managers you will trust to manage them.

Start with costs

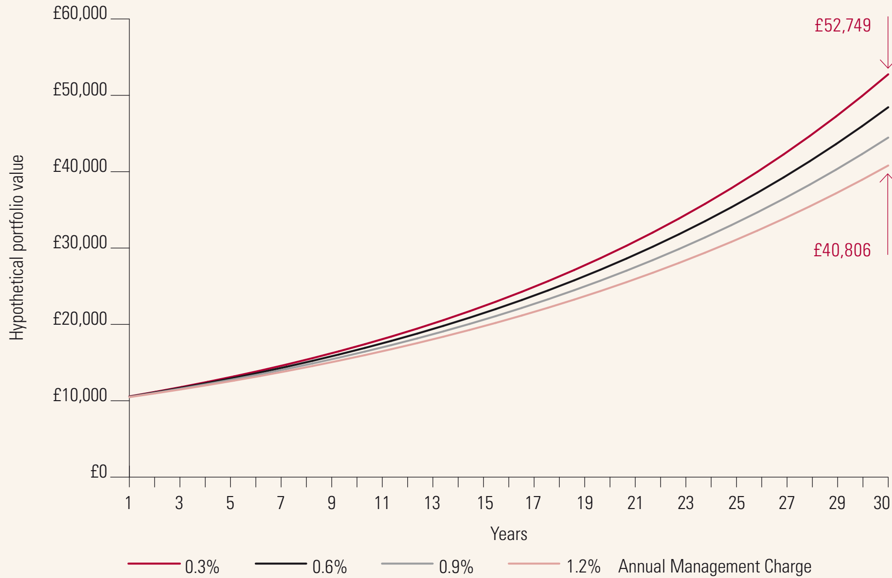
Whether you choose index or active managers you increase your chance of outperformance by focusing on those with lower fund costs, because you get to keep more of any return the funds achieve.

Using a hypothetical example (which does not represent any particular investment), the graph illustrates the potential impact of costs on an initial investment of £10,000 over a 30-year period. This graph assumes 6% average growth per annum which is compounded year on year. As this shows, an Annual Management Charge (AMC) of 0.3% compared to an AMC of 1.2% could potentially lead to savings of £11,943 over a 30-year period.

Your financial adviser understands the nature of investment costs and can be instrumental in ensuring that your portfolio is as cost effective as possible.

It is important to note that cost is not the only factor. This example assumes growth of 6%, but in reality returns may vary and you may get a lower return from a fund with lower investment costs.

Growth of a £10,000 initial investment over a 30 year period, assuming 6% growth per annum



This hypothetical example assumes an investment of £10,000 over 30 years. Annual compounding is used for both the assumption of 6% average growth p.a. and the investment costs. Costs are applied to average annual growth of 6% for each year. As it is a hypothetical, this example does not represent any particular investment.

Source: Vanguard

The four Ps

One way to breakdown and analyse fund managers it by looking at the four Ps: people, philosophy, process, and performance.

People
Always ask about the experience and expertise of the fund managers – and find out how long they've actually been running their fund. This applies to both active and index managers.

Philosophy
Check that the firm has a genuine commitment to the long term, and that they have an investment philosophy with which you feel comfortable. In the case of index managers, you will want to know how they approach the challenge of replicating the index returns.

Process
Some firms give managers much more leeway than others. How much discretion do you want your fund manager to have? With index funds, you will want to examine the way they go about implementing their index strategy.

Performance
Past performance is perhaps the least reliable predictor of future results. Investors need to consider a fund's record in context, and ask: is recent success consistent with the firm's general investment philosophy and process? You should also look back over the long-term performance, always comparing this with the relevant benchmarks. This is true of both index and active managers.

Choosing an index manager

Check the history of the fund against its index to see how closely it replicates the index performance. Despite having the same basic goal of tracking an index, different index funds that seek to track similar benchmarks can deliver very different results.

Next, how well various fund managers have tracked your chosen index. This is largely determined by each fund's charges, as fund operating costs eat directly into the returns you receive.

Choosing an active manager

If you decide to invest in an actively managed fund, it's much harder to predict which manager will outperform the benchmark. Nobody can see into the future and as every investor should know, past performance is not a reliable indicator of future returns. However, one indicator appears at least semi-reliable: cost. There are costs and charges in making any investment. By keeping costs to a minimum, you improve your potential returns. Again, this is because costs eat into the real returns a fund can deliver, particularly over longer time periods.

You should also find out if they take an individual talented fund manager (who might leave) or a team-based approach (and if this team is likely to remain with the fund). Find out how long managers tend to stay with the same firm. It's also worth researching the history and the resources of the fund management company, and asking if they have a succession plan to ensure stability if a key manager leaves. Also check on the investment style: whether they pursue growth, value or a blend of both.

Compare fund managers to benchmarks, not peers

Remember to measure any manager's performance against the actual benchmark for the fund, not against other similar funds. Over the long term, fund managers have generally fallen behind their benchmarks.

Active and passive investing: key points at a glance

	Active management	Passive management
In essence	**Aims to outperform the market** An active manager selects some shares (or bonds) in preference to others.	**Tracks a specific index** A passive fund reflects the market or a market sector (such as technology or smaller companies) as a whole, and so does not depend on a manager making the right decisions.
Techniques	**Stock-picking** Active managers analyse the market in order to identify and purchase investments that are undervalued (and to sell investments that become overvalued).	**The replication approach** A very straightforward way to track an index. A manager buys the same shares as are in the index, in the same proportions as they are weighted in the index. **The sampling approach** Useful when the index is very large or complex. Here, a manager uses mathematical models to buy a range of securities.

What next?

This guide has covered portfolio construction. We explored the key stages of portfolio construction including:

- Asset allocation
- Sub-asset allocation
- Balancing active and passive strategies
- Picking funds and fund managers

Now, you're ready to work with your financial adviser to begin constructing your portfolio.

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Our Client Services team is available
Monday to Friday from 09.00 to 17.00.

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