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COLUMBIA THREADNEEDLE INVESTMENTS

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INVESTOR GUIDE
ASSET ALLOCATION

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To help your understanding where we refer to specific terms, we have included a glossary on page 10.

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01
WHAT IS ASSET ALLOCATION?

Investing is all about risk and return. Most rational investors would prefer to maximise their returns, but every investor has their own individual attitude towards risk. Moreover, the potential returns available from different kinds of investment, and the risks involved, change over time as a result of economic, political and regulatory developments as well as a host of other factors.

Asset allocation is the process that seeks to balance these risks and returns to meet the requirements of investors, and to manage that balance actively as economic conditions change.

As we will see, portfolios can incorporate a wide range of different assets, all of which have their own characteristics. Understanding these characteristics, and their implications on how a portfolio will perform in different conditions, is a key step in the asset allocation process.

02
WHY DIVERSIFY?

If we could see into the future there would be no need to diversify our investments. We could merely choose a date when we needed our money back, then select the investment that would provide the highest return to that date. It might be a company share, or a bond, or gold or any other kind of asset.

The problem is that we do not have the gift of foresight. We can use current information to forecast what is likely to happen in the future, but we can never be sure.

Diversification helps to address this uncertainty by combining a number of different investments.

At the most basic level, if you invest in the shares of two companies rather than one, the likelihood of losing all your money is lower because it is less likely that both of them will go out of business than just one of them – especially if they are operating in different industries. By the same token, the gain will be lower than if you had just chosen (with perfect foresight) the better-performing of the two.

This is illustrated by the chart opposite (Figure 1), which shows the performance of two different assets, and a 50:50 combination of the two. You will see that the combination achieves a lower final return than the better performing of the two, but with lower volatility and a smaller maximum loss.

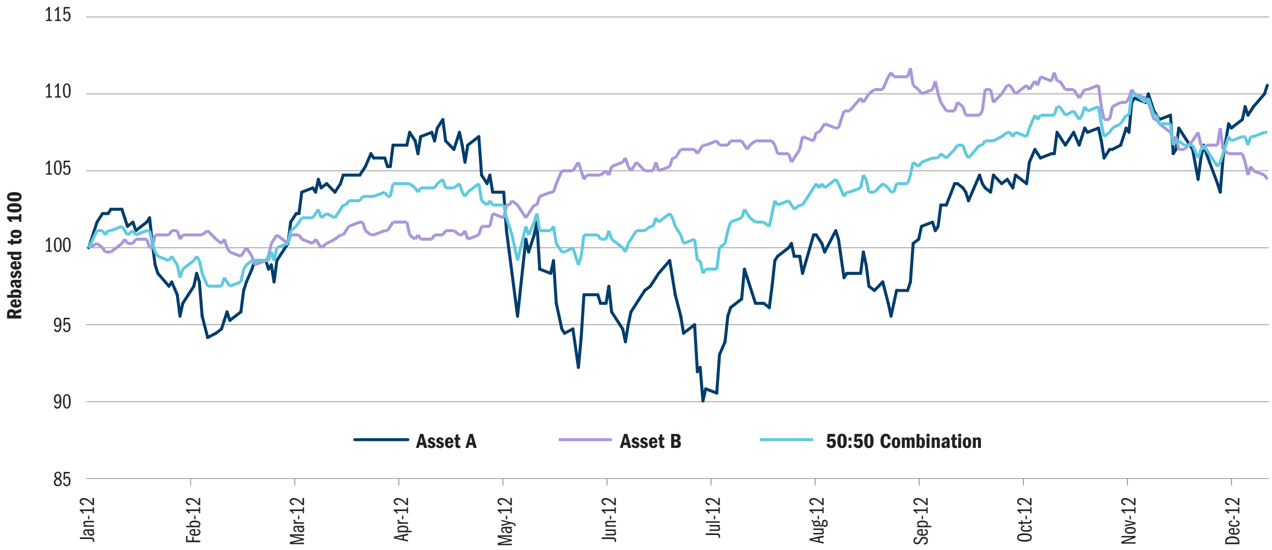
This is what we are trying to do when we diversify: to narrow the range of possible outcomes.
Most people are prepared to sacrifice some of the potential for dramatic gains in order to minimise the risk of significant losses.

The principle of diversification can be extended further by investing in different asset classes.

For example, if you invest in a company share and a government bond, the chances of losing all your money should be lower still.

You might even choose to invest in two things whose prospects will react oppositely to changes in the investment background. Then, losses in one should be offset by gains in the other. In this instance, your gain is likely to be significantly lower but so is the potential loss.

Figure 1: Diversification between two assets. Please note the data below is for illustrative purposes only.



Fund managers seek to combine different investments efficiently, so as to minimise risk without compromising returns. As such, investing in professionally managed funds rather than directly is a popular way of gaining a healthy level of diversification. Most fund providers offer a range of active funds investing in various markets. Many also offer "managed funds" which combine portfolios from different asset classes into a "fund of funds" in order to provide further diversification.

The effect of combining different assets on a portfolio's risk and return depends on the degree to which the performance of the assets is correlated.

CORRELATION EXPLAINED

The prices of different assets are affected by different factors. For example, equities (shares in companies) respond to changes in the profit outlook of the businesses involved, while government bonds are driven more by expectations for inflation and interest rates. As such, they react in different ways to changes in the economic background. Correlation is a measure of the extent to which one investment moves in tandem with another.

Correlations between pairs of assets range from -1 to +1. A score of +1 means that the two assets are "perfectly positively correlated", i.e. they always move exactly in tandem. A correlation of -1 means that they are "perfectly negatively correlated", meaning that they move in exactly opposite directions at all times. A score of zero shows that they are "uncorrelated", which means that the performance of one bears no relation to the performance of the other – sometimes they move together, sometimes they do not.

Correlation is a mathematical formula based on regular observations of historic price changes. As such, it is backward-looking, and degrees of correlation can and do change over time. However, in general, relatively similar assets (e.g. the shares of two companies operating in the same industry, or the bonds of two well-financed, developed countries) will tend to be more highly correlated than assets that are driven by different factors.

When combining assets to minimise risk without compromising returns, we aim for correlations close to zero. The table below shows the example correlations of various asset classes over a three year period. It should be remembered that these are example figures. However, they do illustrate the relationships between different kinds of investment.

Figure 2: Correlation of different asset classes – for illustration purposes only

	UK Equities	Global Equities	UK Government Bonds	Global Government Bonds	UK Corporate Bonds	UK Commercial Property	Commodities
UK Equities		0.94	-0.06	-0.16	0.52	0.35	0.49
Global Equities	0.94		-0.14	-0.27	0.43	0.40	0.46
UK Government Bonds	-0.06	-0.14		0.84	0.50	-0.32	-0.20
Global Government Bonds	-0.16	-0.27	0.84		0.42	-0.29	-0.13
UK Corporate Bonds	0.52	0.43	0.50	0.42		0.20	0.12
UK Commercial Property	0.35	0.40	-0.32	-0.29	0.20		0.23
Commodities	0.49	0.46	-0.20	-0.13	0.12	0.23	

Source: Columbia Threadneedle Investments Indices used are the FTSE All Share, the MSCI AC World Index, the FTA All Stocks, the JPM Global Government Bond Index, the iBoxx Sterling Non-Gilt Index, the IPD Index and the DJUBS Commodities Index. Please note the above figures are used for illustrative purposes only.

03 ASSET CLASSES – THE BUILDING BLOCKS OF YOUR PORTFOLIO

When putting together a portfolio there are a number of asset classes, or types of investments, that can be combined in different ways. The starting point is cash – and the aim of employing the other asset classes is to achieve a better return than could be achieved by leaving all of the investment on deposit. We describe below the main asset classes and some of their key characteristics.

CASH

Money held in the bank is arguably more secure than any of the other asset classes, but it is also likely to provide the poorest return over the long term. Indeed, with inflation currently above the level of interest provided by many accounts, the real value of cash held on deposit is falling.

BONDS

Bonds are effectively IOUs issued by governments or companies. In return for your initial investment, the issuer pays a pre-agreed regular return (the "coupon") for a fixed term, at the end of which it agrees to return your initial investment. Depending on the financial strength of the issuer, bonds can be very low or relatively high risk, and the level of interest paid varies accordingly, with higher-risk issuers needing to offer more attractive coupons to attract investment.

As long as the issuer is still solvent at the time the bond matures, investors get back the initial value of the bond. However, during the life of the bond its price will fluctuate to take account of a number of factors, including:

- **Interest rates** – as cash is an alternative lower risk investment, the value of government bonds is particularly affected by changes in interest rates. Rising base rates will tend to lead to lower government bond prices, and vice versa.
- **Inflation expectations** – the coupons paid by the majority of bonds do not change over time. Therefore, high inflation reduces the real value of future coupon payments, making bonds less attractive and driving their prices lower.

- **Credit quality** – the ability of the issuer to pay regular coupons and redeem the bonds at maturity is a key consideration for bond investors. Higher risk bonds such as corporate bonds are susceptible to changes in the perceived credit worthiness of the issuer.

EQUITIES

Equities, or shares in companies, are regarded as riskier investments than bonds, but they also tend to produce superior returns over the long term. They are riskier because, in the event of a company getting into financial difficulty, bond holders rank ahead of equity holders when the remaining cash is distributed. However, their superior long-term returns come from the fact that, unlike a bond, which matures at the same price at which it was issued, share prices can rise dramatically as a company grows.

Returns from equities are made up of changes in the share price and, in some cases, dividends paid by the company to its investors. Share prices fluctuate constantly as a result of factors such as:

- **Company profits** – by buying shares, you are effectively investing in the future profitability of a company, so the operating outlook for the business is of paramount importance. Higher profits are likely to lead to a higher share price and/or increased dividends, whereas sustained losses could place the dividend or even the long-term viability of the business in jeopardy.
- **Economic background** – companies perform best in an environment of healthy economic growth, modest inflation and low interest rates. A poor outlook for growth could suggest waning demand for the company's products or services. High inflation could impact companies in the form of increased input prices, although in some cases companies may be able to pass this on to consumers. Rising interest rates could put strain on companies that have borrowed heavily to grow the business.
- **Investor sentiment** – as higher risk assets, equities are susceptible to changes in investor sentiment. Deterioration in risk appetite normally sees share prices fall, while a turn to positive sentiment can see equity markets rise sharply.

The global equity market is very varied, and affords the opportunity to invest in start-up companies at home or abroad, or to share in the income generated by more mature businesses. Shareholders are also part-owners of the companies that they invest in, which means that they can influence the management when it comes to strategic decisions such as potential takeovers.

COMMODITIES

Commodities are the raw materials that power the global economy, and recent regulatory developments have made it much easier for investors to access this exciting market in their portfolios. Among the key areas are:

- **Energy –** the largest component of the commodity markets, including oil and natural gas. These commodities have been traded for many years and their prices affect consumers and companies alike.
- **Base metals –** including aluminium, copper and nickel, which are key inputs to the global manufacturing industry.
- **Precious metals –** such as gold and silver, which have intrinsic value in their own right as well as being used in some industrial processes.
- **Agricultural commodities –** grains, seeds, soft commodities like coffee and sugar and even livestock are traded globally.

Commodity prices change constantly and are affected by factors such as:

- **Global economic growth** – robust economic activity boosts demand for many commodities, particularly those used in the manufacturing industry.

- **Supply** – some commodities, such as precious metals, are in very limited supply, while others such as soft commodities are seasonal and dependent on growing conditions and weather patterns. Meanwhile, oil is often produced in locations where technical malfunction or geopolitical events can disrupt production. Changes in the outlook for supply can dramatically affect all commodity prices.
- **The appeal of other assets** – precious metals can receive an additional boost from weakness in other assets such as global currencies. When global reserve currencies such as the US dollar and the euro are weak, investors often flock to gold as a store of value. Global inflationary concerns can have a similar effect.

PROPERTY

In investment terms, property normally means commercial real estate – offices, warehouses, retail units and the like. Unlike the assets we have mentioned so far, properties are unique – only one fund can own a particular office building or shop. Therefore, bottom-up research of individual locations and local market conditions, together with a good network of industry contacts, are important ingredients in successful property investing.

The performance of these assets can sometimes be dominated by changes in capital values, as was the case in the crash of 2007 and the subsequent sharp recovery in 2009 and 2010. These unusually dramatic moves in capital value illustrate another of property's key characteristics, namely its relative illiquidity compared to equities or bonds.

Buying equities, bonds or commodities is normally a relatively quick and inexpensive process, but property investing involves considerable valuation and legal involvement. As such, the process is longer and dealing costs are higher. When there is a wholesale trend towards selling property, as was the case in 2007, prices can fall significantly. Conversely, when there are more buyers than sellers, as happened in 2009, price rises can be swift.

The more normal state of affairs is for rental income to be the main driver of commercial property returns. Owners of property can enhance the income potential and capital value of their assets by undertaking refurbishment work or other improvements. Indeed, without such work, property can quickly become uncompetitive and run down.

When managed properly, the relatively stable nature of property's income return is key to its appeal for investors.

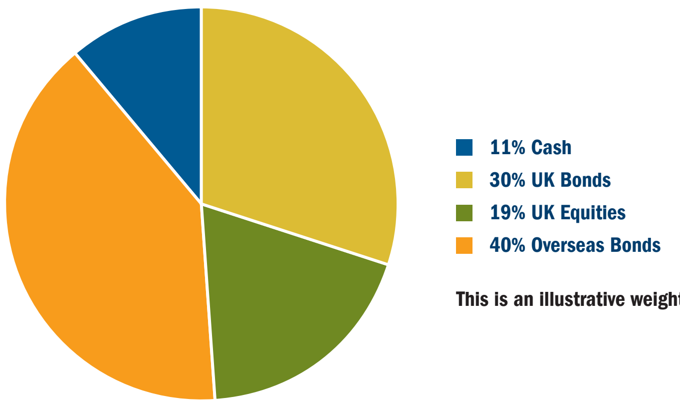
ESOTERIC INVESTMENTS

We have examined the principal asset classes available to mainstream investors. However, further diversification can be achieved by incorporating esoteric investments such as fine art, vintage cars, furniture or forestry into portfolios. Some of these areas are difficult to analyse rationally, as they involve an element of emotional value and can be subject to trends. This is one of the reasons why these specialist assets tend to be lowly correlated with more traditional investments.

04
WHAT IS THE RIGHT MIX?

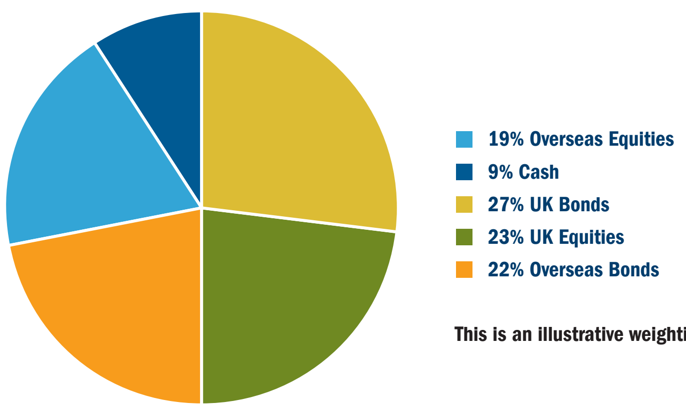
Given the wide variety of investor needs and attitudes, the changing nature of world markets and the range of fund manager views in the market, there is no simple answer to what is the right mix of assets. However, the majority of people fit into one of four risk/return categories, and there is a broad consensus in the fund management industry as to the most appropriate asset mix for each of these groups.

1. **IA Mixed Investments 0-35% Shares –** typified by a relatively low tolerance for risk and more modest expectations for returns, these investors will tend to focus more on domestic assets and are likely to incorporate a significant weighting in bonds.



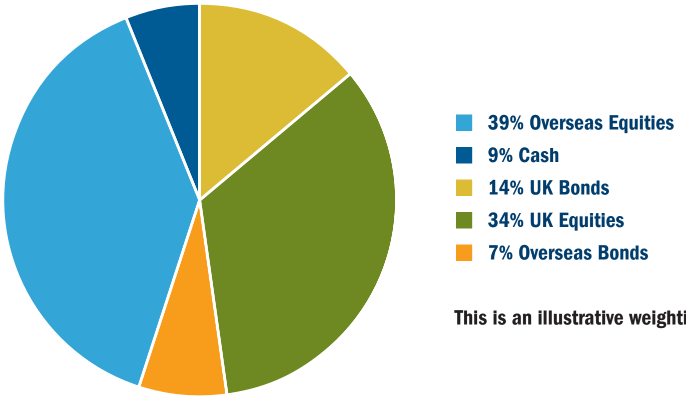
This is an illustrative weighting.

2. **IA Mixed Investments 20-60% Shares –** a slightly greater appetite for risk and the desire for higher returns leads this group to adopt a bigger weighting in equities and to incorporate more overseas exposure.



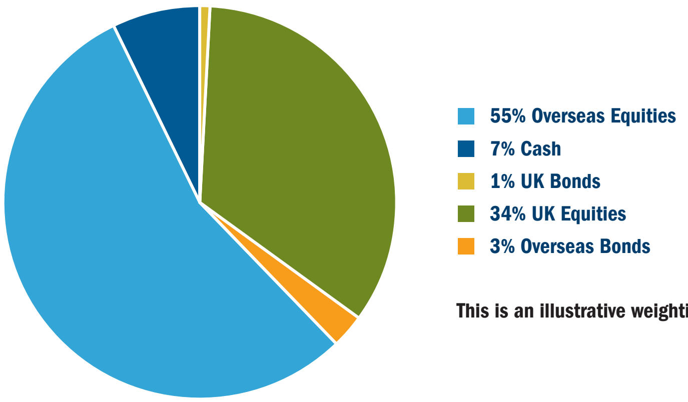
This is an illustrative weighting.

3. IA Mixed Investments 40-85% Shares – investors who are prepared to accept higher levels of risk in pursuit of attractive long-term returns will typically allocate the lion's share of their portfolios to equities, with a meaningful weighting in more adventurous overseas markets.



This is an illustrative weighting.

4. IA Flexible Investment – the funds in this sector are permitted to invest in a range of different investments, with no minimum or maximum requirements on any particular asset class or currency.



This is an illustrative weighting.

05
MANAGING THE MIX

In order to maximise the performance potential of a diversified portfolio, managers actively change the mix of assets they hold to reflect the prevailing market conditions. These changes can be made at a number of levels including the overall asset mix, the target markets within each asset class and the risk profile of underlying funds within markets.

As a rule, an environment of positive or recovering economic growth and healthy risk appetite would be likely to prompt an increased weighting in equities and a lower exposure to bonds. Within these baskets of assets, the manager might also move into more aggressive portfolios when markets are doing well and more cautious ones when conditions are more difficult. Geographical factors such as local economic growth, interest rates and the political background will also affect the weighting between markets within equities and bonds.

Finally, in the underlying portfolios, managers will normally adopt a more defensive positioning when risk appetite is low. For example, in equities they might have higher weightings in large companies operating in parts of the market that are less reliant on robust economic growth. Conversely, when risk appetite is abundant, underlying portfolios will tend to raise their exposure to more economically sensitive parts of the market and to smaller companies.

HOW DO I BUILD MY OWN DIVERSIFIED PORTFOLIO?

Some investors choose to build their own portfolios, either by buying shares, bonds and other assets directly or by combining funds investing in each area. However, this is a very time-consuming approach and it can be difficult to keep abreast of developments in the markets, whilst also researching all the funds on offer. For this reason, most investors prefer to place their portfolio into the hands of professional managers, and to entrust the selection of those managers to a financial adviser.

Your adviser will be able to help you clarify your investment needs and will also assess your attitude to risk. Armed with this information, they will be able to assist you in assembling a portfolio with the appropriate level of diversification and the right mix of assets to help meet your requirements.

06
GLOSSARY

Asset allocation: the process of setting the mix of different investments in a portfolio.

Asset class: a generic type of investment, such as equities, bonds or cash.

Bonds: investments that pay a pre-agreed, regular income over a fixed term.

Commodities: raw materials such as oil, gold, coffee and livestock.

Correlation: the extent to which one asset's price moves in tandem with another.

Coupon: the agreed level of income paid by a bond.

Diversification: spreading investments across different assets in order to reduce risk.

Dividend: income paid by companies to their equity investors.

Equities: shares in companies.

Esoteric investments: non-mainstream assets such as fine art, furniture, vintage cars and forestry.

Fund of funds: see managed fund.

Inflation: The rate at which the general level of prices for goods and services is rising.

Investment Association The Investment Association represents the UK investment management industry.

Managed fund: a portfolio made up of several underlying funds that invest in various asset classes. Also known as fund of funds.

Multi-Asset fund: a recently-introduced type of managed fund that includes commodities, property and hedge funds as well as the traditional asset classes.

Property: in an investment sense, this normally means commercial real estate such as offices, retail units or distribution warehouses.

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* Please note we record calls for your protection and to improve our standards

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