Skandia

principles of investment

building an investment portfolio

This 'principles of investment' factsheet aims to give you the foundation you need to start understanding investment decisions with regard to portfolio construction. Topics covered include:

- where to begin
- things to consider
- what is your risk profile?
- get going!
- reviewing your investment portfolio

where to begin

To the novice investor, the world of investments can seem a daunting place. Consulting a financial adviser prior to making long-term investment decisions is always a wise move.

Even with advice, it is important to have a broad understanding of how investment decisions are made before creating an investment portfolio. There are many factors that ultimately contribute to how you and your advisor shape your investment portfolio; this piece will help you understand the importance of these factors.

things to consider

Attitudes toward risk can differ greatly and is largely dependant upon the varying circumstances of individuals. As an investor there are a number of key things that you need to consider in order for your financial advisor to ascertain your risk profile.

Each investor is different. You might have children to support or you might have already retired and need to ensure that your investments are secure. On the other hand, you might be prepared to accept a higher exposure to risk in return for potentially larger returns. This is something your financial advisor will want to determine.

Here are some of the considerations when constructing an investment portfolio:

Age and investment duration

Your age may dictate how long you wish to invest for. For example a young professional investing in a pension may be more likely to take higher levels of risk, due to the length of time available to recoup any short-term losses. Alternatively, an older couple may be far more cautious with any accrued savings, as they will be keen to preserve capital to support their retirement.

Additionally, if you are investing for the short term, say two years, it would be wise to invest in a way that you can access your investment easily, without facing any charges. Note that investing in shares is usually considered to be a long-term commitment.

Investment objective

As an investor you may be looking for the value of your investment to increase over time, perhaps to purchase a second home or finance your childrens' education. Or you may be looking for your investments to provide an income - maybe for retirement. Alternatively, you could be hoping your portfolio will provide you with both. You need to determine your investment objective before deciding the 'make-up' of your portfolio.

Size of Investment

Those investing comparatively small amounts may not be able to take full advantage of diversification if investing in individual shares on the stock market. However, collective investment funds, like unit-trusts, offer investors with smaller 'pots' the capability to achieve diversification.

Current savings

If you have a substantial pot of savings, separate from your investment portfolio, you may be more likely to take higher risks with this portfolio, safe in the knowledge that you have additional funds elsewhere. Alternatively, if the only savings you have are invested, you may be wary of any significant drop in their value and act more cautiously as a result.

Attitude to losses

Clearly defining how much of a loss you are prepared to accept as a percentage of your portfolio is vital. Your financial adviser may try to ascertain your risk profile by assessing your reaction to short-term losses upon being given a hypothetical investment scenario.

For example, if you would accept a loss of less than 5% you are definitely a risk averse investor. But if you are prepared, in the short term, to lose more (for example 20-25%) you might be considered a high risk investor.

Another useful test is to assess, hypothetically, how you would respond to a loss on your investments. For example, if your portfolio drops 20% in one year, would you change your holdings, sit tight, or even invest more?

Existing financial commitments

It is important that your portfolio reflects any significant financial commitments, such as a mortgage to repay or a family to support. If you had to rely on your investments to meet these commitments then a high risk approach may not be entirely appropriate.

what is your risk profile?

Various tools exist to assist your financial adviser when making these assessments. 'Risk questionnaires', for clients to fill in with the advisor are just one way of discussing the considerations mentioned above and will enable your adviser to decipher which risk profile best suits you:

A low risk profile

If you tend to prefer a cautious approach to investments, your adviser will consider you to be a low risk investor or risk averse. This means you place greater importance on preserving the capital value of your investment over increasing its value.

The low risk investor may choose to invest in the lower end of the risk scope, perhaps predominantly in bonds rather than shares.

A medium risk profile

If you can tolerate some fluctuations and volatility, but tend to stay away from investments that may dramatically or frequently change in value, you might be an investor who can accept medium levels of risk.

The medium risk investor may have a long-term goal for the investment; possibly looking for long-term capital gains with the added benefit of a short-term income stream. The combination of shares and bonds will differ slightly from the low risk investor - the allocation to shares is likely to be slightly higher.

A high risk profile

On the other hand, if you are willing to accept a greater possibility of a decline in the value of your investment in return for potentially higher returns, you are more than likely to be considered a high risk investor. You will be prepared for the possibility of losing a large proportion or all of the money invested.

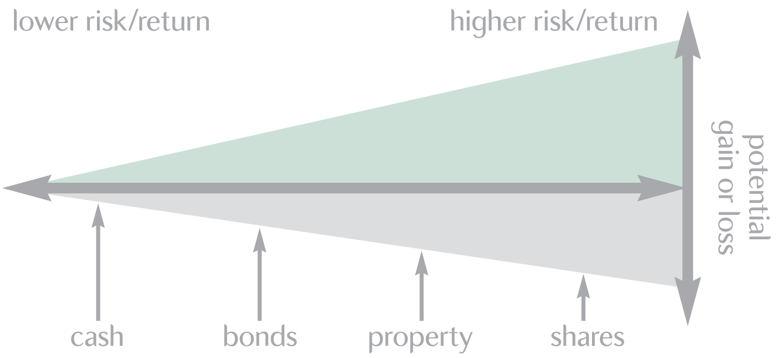
Typically, a high risk investor may be younger and investing for the long term. This means that, should their investments suffer a loss, there is time for them to recover. This type of investor is likely to be interested in the financial markets and take a more active role in their investments. Smaller company shares or investment funds are likely to make up a proportion of their portfolio and the excitement and rapid growth of emerging markets may also be attractive. The high risk investor favours shares over bonds and will sleep soundly at night despite the risk of losing money!

Asset Allocation:
The process of dividing investments among different kinds of assets, such as shares, bonds, property and cash, to optimise the risk/reward trade-off based on an individual's specific situation and goals.

get going!

Now that you are aware of the major considerations to take into account when creating your portfolio and your financial adviser has helped you to identify which risk profile best suits you, it is time to decide where to invest.

Different asset classes have different risk/return characteristics, as illustrated in the diagram, to the right.



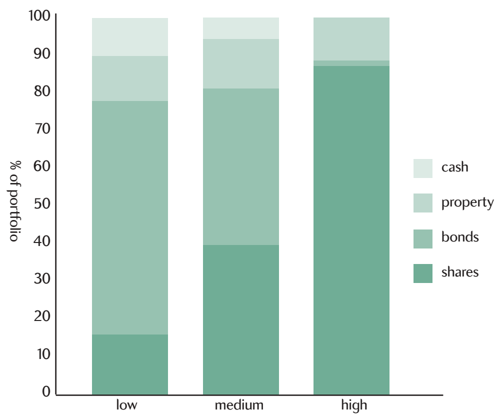
Your financial adviser will take into consideration all of the information gathered, including your investment objective and risk profile, to ascertain the most appropriate blend of asset classes.

Generally speaking, risk averse or **low risk investors** tend to construct portfolios with a bias for cash and bonds, with less exposure to shares. Despite a low potential for significant capital growth, a portfolio with this structure is likely to be far less volatile than one with a high weighting in shares and may also provide an income stream to the investor.

Medium risk portfolios are likely to have a more balanced weighting between bonds and shares, with perhaps some exposure to property and cash also. This type of portfolio is likely to provide capital growth from the share component and derive an income stream from the bond segment.

A **high risk** portfolio often apportions the majority of the investment to shares, with less exposure to bonds and cash. Whilst the value of the investment may rise quite significantly over the long term, the volatile nature of shares means that there is a risk that the portfolio is vulnerable to dramatic reductions in value.

By using a portfolio construction tool that we have developed for financial advisers, we have generated example asset allocations for low, medium and high risk investors over the same investment duration (see graph, right). You will see how, depending on the investor's risk profile, the weighting to the different asset classes change. Note the bond bias for the low risk investor, moving to a larger proportion in shares for the medium and high risk profiles.



Allocations produced using the Optimised Portfolio Model on Skandia's USelect, for a life product. Investment duration 8 -12

These are examples only and should not be perceived as recommendations. Your financial adviser will be able to recommend an asset allocation to suit your risk profile and investment time horizon.

one rule of thumb is to never 'fall in love' with any specific investment – always objectively re-analyse the progress of your portfolio.

reviewing your investment portfolio

Having now built your portfolio, it is important that you and your adviser continually review its progress.

The financial market is constantly changing, providing new possibilities for growth and opportunities to prosper. Alternatively, the market may well decline, forcing you to address your portfolio and perhaps adapt your allocations within the new conditions.

Faced with deteriorating returns, you may have to decide between cutting your losses and investing in more conservative assets, or maintaining and even increasing your investments in the belief that prices are low and will eventually recover.

Furthermore, and perhaps more importantly, individuals' circumstances change. For example a new addition to the family or a loss of a job can have a dramatic effect upon an individual's financial situation - demanding that their investment portfolio be re-addressed.

One important rule of thumb is to never 'fall in love' with any specific investment – always objectively re-analyse the progress of your portfolio and rebalance accordingly. Only then will you reduce risk and take full advantage of opportunities that occur in the market.

and finally...

There is no doubt that it is possible to build a comprehensive portfolio of investments to suit the risk profile and goals of each individual investor.

However, building a truly diverse and successful portfolio is a complex process. Even with the 'know how' of a financial adviser, it is useful to gain a general understanding of how portfolios can be tailored to suit your specific needs and goals. Only then will you be truly confident that you are in control of your investments.

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