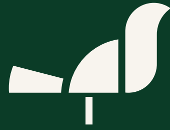

SMARTER FINANCIAL PLANNING

Our Investment Philosophy and Process

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Our Investment Philosophy

What is an Investment Philosophy?

It describes our approach to managing your money. It also describes how you're involved in the decisions about investing; after all, it's your money.

Our Belief No.1

Investors should understand the reasons for investing and how their portfolio is designed to meet their goals.

The world of investing can be complex. We believe in keeping things simple. So while there is a lot of science and evidence behind our investment philosophy and process, we are keen that every client understands our recommendations and how they fit with their own financial objectives.

The first step of any investment philosophy is for us to understand your needs. We explore this by chatting with you and looking to factors such as:

- Your need for capital security.
- Your age.
- Your family commitments.
- The need for income and / or growth and any future regular income needs.
- Whether there is a specific item that needs funding e.g. school fees.
- Your investment time horizon.
- Your exposure to interest rate risk and inflation risk.
- The impact of charges and penalty fees.
- Your attitude to risk, risk tolerance and capacity for loss.

The output from this helps us to make decisions about the level of investment risk that needs to be taken.

Our Belief No.2

A conversation about risk and its many dimensions is the essential first step when investing.

When it comes to investing, risk and reward are inextricably entwined. Don't let anyone tell you otherwise. All investments involve some degree of risk - it's important that you understand this before you invest.

The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to do better by carefully investing in asset categories with greater risk, like equities, rather than restricting your investments to assets with less risk, like cash. On the other hand, investing solely in cash investments may be appropriate for short-term financial goals. To help understand risk we break it down into four elements:

Investment risk. These are the risks associated with different types of investment. There are many different risks (and rewards) but common ones include: volatility – the ups and downs; liquidity risk – can you get your money back when you need it; company risk – the risk that one company goes bust; default risk – the risk that a bond doesn't pay you back; emerging market risk – the fact that some markets are less efficient and transparent.

The need for risk. All these risks might start to put you off. But even investing in cash carries risk e.g. inflation risk – your spending power goes down; default risk – your deposits may not be 100% safe. For some investors, and certainly for short term savings, cash is still likely to be the best fit with your needs and objectives.

Your attitude to risk. Risk attitude has more to do with the individual's psychology than with their financial circumstances. Some will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues.

Your ability to tolerate risk / accommodate losses. If things go wrong what would that mean to your finances? You may be a risky investor but can you afford to be? You may be a risk averse investor but are you saving enough? This is about understanding your ability to withstand the shocks that might come along with the aim of ensuring your portfolio meets your capacity for risk.

Generally speaking, a person with a higher level of wealth and income (relative to any liabilities they have) and a longer investment term will be able to take more risk, giving them a higher risk capacity.

Your ability to tolerate risk is very different to your attitude to risk – understanding this is a key part of our investment process. A conversation with you will help inform decisions about the level of investment risk that needs to be taken and that you can afford to take, rather than simply the maximum amount of risk that you feel happy with.

We will use a specialist risk profiling tool to help us establish the risk profile that is right for you. But we will also have a conversation with you about the profile to make sure that you understand what it means and how the profile needs to change to meet your particular situation. The great benefit of the tool is that it creates an unbiased view of your risk profile, and therefore is an excellent starting point for the conversation.

Our Belief No.3

Investing for the long term is very different than saving for the short term.

While there is an understandable desire to keep things safe when investing, the corrosive impact of inflation and thus the value of investing for the long term in more risky assets are compelling.

Real assets such as equities, property and commodities tend to make a better investment than the apparently safer option of cash deposits in the long run, but it isn't that simple.

In the last 50 years Equities have outperformed Gilts.

Asset Class	Return
Equities	5.6
Gilts	2.9
Cash	0.8

Real returns (after inflation) over 50 years %pa. Source: Barclays Research 2019.

But it isn't the case over every time period – for example over the twelve most recent 10 year periods going back to 1902 (1902 – 1912, 1912 – 1922 etc.) – Equity returns were better than Gilts eight times, whereas Gilts beat Equities four times.

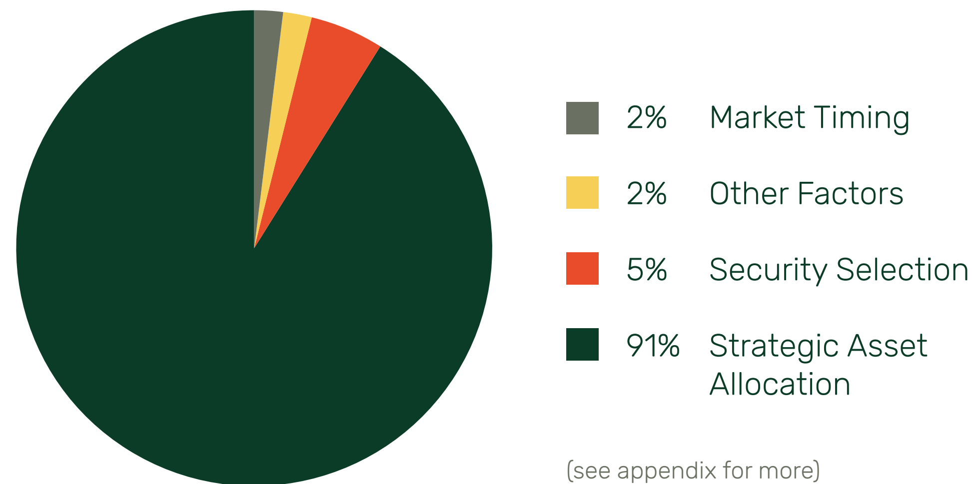
Investing is for meeting long-term goals; saving is for short-term goals. Money that investors may need in the short-term (less than three years) should be kept in short-term investments which protect capital. These include bank accounts, or government bonds (Gilts), or money market funds (a fund that invests in short-term financial instruments such as cash). Clients should only consider investments in the stock market or bonds when they have money to put away to help meet a longer-term objective.

Our view is that basing investment decisions on the longer term historic behaviour of asset classes enables investors to participate in market growth. But that regular review is critical.

Our Belief No.4

The bulk of long-term returns come from asset allocation.

Academics will continue to argue about the precise amount of value that comes from strategic asset allocation rather than stock selection, investment style or market timing, but it is widely accepted that asset allocation has the biggest influence over the variance in portfolio returns.



(see appendix for more)

This means that investors and their advisers should be devoting the bulk of their effort to constructing the most suitable asset allocation model, based on individual investment objectives and individual attitude towards investment risk. This is where we focus our attention when delivering investment advice.

It's like making a cake. The most important part is making sure you have the right amount of flour, eggs, butter etc. rather than worrying whether the ingredients come from Harrods or the corner shop.

We use the risk profiling tool to propose a suitable asset allocation to meet your needs based on long term historic information. We will discuss this with you to make sure that you are comfortable with the recommendations.

Our Belief No.5

Diversification using mainstream asset classes can reduce risk without destroying returns.

Diversification is a strategy that can be neatly summed up by the timeless adage 'Don't put all your eggs in one basket'. The strategy involves spreading your money among various investments with the intention that if one investment loses money, the other investments may more than make up for those losses.

A diversified portfolio should be diversified at two levels: between asset categories and within asset categories. So, in addition to allocating your investments among stocks, bonds, cash, and possibly other asset categories, you'll also need to spread out your investments within each asset category.

Investors may find it easier to diversify within each asset category through the ownership of mutual funds (unit trusts), rather than through individual investments from each asset category. A mutual fund is an investment vehicle that pools money from many investors and invests the money in stocks, bonds, and other financial instruments. Mutual funds make it easy for investors to own a small portion of many investments. A total stock market index fund, for example, may own stock in hundreds of companies. That's a lot of diversification for one investment.

We use specialist fund managers to build portfolios that are diversified at both asset class and stock level. But importantly they stay close to the asset allocation outcome which has been determined as appropriate for you.

The use of these so-called multi-asset approaches has the benefit of 'automatic rebalancing' inside the fund wrapper. This means that the asset mix of these portfolios stays true to the asset allocation that meets your risk need, and is often conducted at lower cost than we can probably achieve by rebalancing it directly. It will take us some time to implement the switches for each client and each fund in each tax wrapper - automatic rebalancing reduces this cost and is especially efficient for smaller portfolios. Also that fact that switching portfolios outside the fund wrapper which could lead to Capital Gains Tax (CGT) liability is removed.

Our Belief No.6

Costs are certain and returns are not – so they deserve your attention.

Costs are certain and fund performance is not. It therefore makes sense to reduce costs wherever it is safe to do so. One of the major issues in fund management is that not all the costs are transparent.

There are three main costs with investing in funds:

1. The Annual Management Charge (AMC) – is the fee that the manager charges;
2. The Total Expense Ratio (TER) – this is the AMC plus legal, audit, depositary, safe custody and other costs;
3. Trading costs – these are the costs of buying and selling the investments inside a fund. These include stamp duty, bid / offer spreads, stockbroker commissions, the costs of settling transactions etc.

Even though TERs are not the whole cost of running a fund, they are a powerful predictor of fund returns.

Morningstar (a large global fund ratings agency) conducted analysis in August 2010 to identify the best historic predictors of performance. The results are remarkably clear:

> **"If there is anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision.**

> **In every time period and every data point tested, low cost funds beat high costs funds.**

> **Expense ratios are strong predictors of performance. In every asset class over every time period, the cheapest quintile produced higher total returns than the most expensive quintile."**

Understanding and seeking to reduce costs where safe to do so is a key part of our investment process.

Our Belief No.7

Tax and access are important.

Making investment tax efficient is a sensible objective and wherever we can we will try to reduce the tax your investments will pay. Use of pension wrappers and ISAs will assist in this objective.

We also use new technology platforms, known as wraps or fund supermarkets, to hold your investments. These offer safety, access to your valuations (so you can see how your investments are doing) and tax wrappers (pensions and ISAs for example). They also allow us to move your money between funds cost effectively if we need to in future.

Where possible we try to ensure that investments held can be switched or liquidated without delay in order to allow us to react to unpredicted sudden changes in your circumstances or the investment world.

Our Belief No.8

Active management and passive strategies can both play a valuable role.

There is a role for active (where the fund manager tries to beat the market, but incurs higher costs), and passive funds (which track the index at low cost) within a well-managed investment portfolio.

Consistently outperforming the financial markets is extremely difficult. Economic uncertainties, random market movements, and the rise and fall of individual companies mean it is extremely difficult for anyone – including professional investors – to beat the market in the long term.

Rather than take an evangelical view of one option over the other, we appreciate that there are arguments for both approaches and accordingly we include both strategies in the portfolios we recommend.

Our preferred approach is to use passive funds to form the core of an investor's portfolio. In some cases the whole portfolio will be constructed from passive funds, especially with smaller portfolios to maximise effective diversification, and at lower risk profiles. As a client's risk profile increases we may add active funds which have the potential for higher returns, though the costs will be higher and the risk of not matching the performance of the asset profile will be increased.

To use the jargon – this is about optimising your governance and risk budget – or more simply tailoring the best solution to your needs and financial goals.

Market-timing and performance chasing are losing strategies. Market-timers who buy and sell frequently, hoping to 'catch the wave' as securities rise and fall, need to be very sure that their timing is right. Otherwise, they stand to lose money from market movements while also paying significant transaction costs. As many investors say: it's time in the market that counts, not timing the markets. Also, market fashions change – often very suddenly. There is no guarantee that a performance-chasing strategy, asset class (a type of investment such as stocks, bonds or cash), or fund that has performed well will continue to perform well next year, next month – or even tomorrow.

Our Belief No.9

Investment success comes from the consistent application of a robust process.

There are numerous ways to approach the construction and on-going management of an investment portfolio. Without the application of a robust process, the emotional aspects of investing can prevent investors from making the best decisions. As a firm, we consistently apply a multi-stage investment advice process designed to deliver suitable advice to every client. The outcome is tailored to meet individual objectives but the process itself is always objective.

As with any plan, we need to regularly review progress to make sure we are on track. We will discuss and agree with you the best way to achieve this, so that we understand your needs.

Our Belief No.10

Success is often about the things you don't do as much as the things you do.

We have some simple rules that we apply to all portfolios unless individual clients specifically request a different approach:

1. No individual bonds / shares
2. No direct hedge funds
3. No direct unauthorised funds
4. Only use funds run by FCA regulated managers, with appropriate compensation schemes
5. We use expert managers to help assist in selecting risk managed portfolios.

Our Investment Process

What is an Investment Process?

It outlines how we build the investment portfolios for each of our clients. Our process is based on our investment beliefs.

Principles

- Understanding risk is important.
- Matching your portfolio to your risk profile is essential.
- Asset allocation is the key to success.
- Costs are important.
- Diversification (not putting all your eggs in one basket) is a sound principle.
- Funds are a cost-effective way to access investments for many clients, though specialist managers may be appropriate for part of larger portfolios.

Our approach

Clients

- Risk profiling and the assessment of individual clients' needs are the key inputs – so we will spend time with you to discuss and understand this.
- We also need to understand your need for income and capital growth and any special requirements (such as trust funds, or the desire to leave a legacy).
- Our process is designed to give the best outcome for each and every client commensurate with their risk need – the process is bespoke to each client.

The portfolio

- We know which asset classes we want to use.
- We also know those we wish to exclude such as hedge funds, pure commodities, and unregulated investments due to liquidity concerns, less rigorous regulatory oversight and their opaqueness.
- We have a process for building client portfolios – driven predominantly by asset allocation as this is the biggest driver of return and risk.
- We have investigated how the portfolios are likely to behave (drawdown, return, volatility) and they have been tested historically.
- You should be aware that although we know how the portfolios have performed historically, the future will be different so we need to regularly review them.
- We can map our portfolios to the different risk profiles (including attitude to risk, risk tolerance, time horizon). This is the key to making sure that they are suitable for you.
- Our client portfolios are selected to meet client needs and not the other way round - we are outcome driven, not product driven.

Our process

- Independent expertise is used to enhance our offering.
- We use expert external and internal resources to monitor and select expert fund managers. These in turn research and select the optimum investment funds / stocks for the portfolios from the wide range that are available in the market.
- Our investment process is designed to avoid poor investment funds – as asset allocation and costs are the best predictors of future returns this is where we focus our efforts.
- We use different specialist managers to construct active, passive, and blended portfolios. We may use other specialist mandates as appropriate, for example ethical.

- The portfolios we select are matched to the risk profile that is appropriate for each client – they are monitored on an ongoing basis. Larger portfolios may have a greater divergence from the preferred asset allocation as we give some discretion to managers for part of the portfolio (but only when it is cost effective so to do).
- We use specialist risk profiling tools through FE Analytics and FinaMetrica, which are both leading financial forecasting and planning solutions companies.
- We may restrict the risk level (subject to client override) based on time horizon: This is based on historic drawdown of the asset mixes and is designed to reduce specific client loss.

The portfolios

- Portfolios need to be rebalanced regularly, at least annually is our benchmark, so long as this is in line with the client's risk profile.
- Fund of funds are most effective for smaller portfolios – pooling and rebalancing makes them cost and tax efficient.
- The most effective tax wrapper for the client's tax position may impact the selection of the method of investment.
- The higher the 'risk budget' of the client and the greater their wealth the more potential scope they have for active management.
- For income seeking clients with more than £250,000 of investment, we pay particular attention to the interaction of tax and investment return – to maximise the tax effectiveness of the client's "income".

1. Our portfolio funds service

- For clients who only require one off advice (no ongoing service) we are likely to recommend risk managed multi-manager funds.
- Smaller and lower risk portfolios may be 100% passive.
- The funds will be risk managed to stay closely in line with your risk profile as assessed at outset. If your attitude to risk or capacity for loss changes, then these funds may become unsuitable.

2. Our core and satellite service

- For clients with up to £250,000 we believe that a blended (passive core and active satellite) approach (similar to that adopted by the largest pension schemes in the world) is appropriate.
- We might recommend the smaller portfolio funds service if the portfolio is held in a wide range of wrappers (ISA, PEP, Pension, AVC etc.), that would make it inefficient or too expensive to manage large numbers of small holdings.
- Where we have outsourced the management of the fund of funds to ensure that they are reviewed and monitored on a daily basis, clear guidelines are agreed with the outsourced parties on how the portfolios are managed. Importantly, the mandates are managed in line with the asset allocation that our risk profiling determines so that outcomes are aligned.

3. Our model portfolio service

- For clients with over £250,000 we have a number of solutions:

  i. We may recommend that part of the portfolio is managed on a bespoke basis by a discretionary manager.

  ii. We may recommend the core and satellite service.

- We may still use a passive fund of funds as the core of the portfolio, to keep costs low, and ensure that the portfolio is run precisely to the asset allocation required.
- We will use risk managed and other solutions to meet your needs while still staying close to the overall risk target.

A note on active and passive investing:

- Client input will help to determine the amount of allocation between active and passive, but as a general rule, the higher the risk profile the higher the scope to increase the allocation to active.
- The advantage of passive vehicles is that they can be used to allocate very precisely to the asset allocation of each risk profile. They are also lower cost and thus give higher returns for similar asset class mixes, and they are lower overall risk.
- The advantage of active funds is that the manager can make decisions to move the portfolio to take advantage of market movements or to manage risk. They are higher cost and have higher internal trading costs.

Platform

- Wrap platforms or fund supermarkets offer a cost-effective way for you to access tax wrappers (e.g. pension and ISAs). It also reduces your paperwork.
- We select from a range of platforms, and the decision may be driven in part by the best way to access the selected investment solution (as not all solutions are available on all platforms).
- They also allow you to hold investments from more than one fund manager. Any switches that are made may be faster using platforms.
- You can also see the value of your investments online – some with analysis to see how your investments have performed.
- Platforms also allow us to manage your investment tax effectively – automatic use of your ISA allowances for example.
- Your investments are held by an independent custodian, potentially offering an additional layer of security.
- We select the best platform based on your needs from a shortlist of those in the whole market.
- Our selection of platform will be partly driven by the costs of trading and financial security, scale and functionality.
- If we use a discretionary manager they are likely to use their own investment platform to manage your portfolio – the reports and valuations for this are likely to be quarterly.

Appendix

Three academics, Brinson, Hood and Beebower (1986, Financial Analysts Journal), who studied the performance of 91 large US pension plans between 1974 and 1983, analysed the impact of key decisions made by investment managers: long term asset allocation (i.e. 60% in equities, 40% bonds), stock picking and short term tactical changes to the asset mix. The results concluded that 90% of return and risk in a given fund was determined by the long term asset mix, with both stock picking and short term tactical changes having a negligible impact.

There are a number of key stages we have used when screening managers / funds and other investments.

1. Costs

Fees and expenses (annual management charge (AMC) and (total expense ratios (TER)) are all important to assess. Research has shown that low-cost funds have outperformed high-cost rivals on a consistent basis. Investment companies work on the premise that their high fees are justified by their fund's superior investment returns. The problem is that this simply doesn't stack up in reality. Research by Morningstar in the US concludes that "investors should make 'cost' a primary test in fund selection as it is still the most dependable predictor of performance. Start by focusing on funds in the cheapest or two cheapest quintiles, and you should hopefully be on the path to success."

2. Active or Passive?

A separate research paper has shown that active managers take extra risk and follow the latest trends when things are going badly in pursuit of returns. When the going's good investment managers seem to do well but when things go badly they under-perform simple indexed passive funds. Not exactly what most investors would want to pay for! Our conclusion - base the core of your portfolio around tracker / passive funds. The added benefit is that passive funds are far cheaper than actively managed funds.

3. Portfolio turnover rate

A fund's portfolio turnover rate measures how often a manager buys and sells securities. A high turnover rate indicates that the manager does not hold on to stocks for very long. This may indicate active management but on the flip-side it can lead to higher trading costs and indicate a short term investment approach. These costs are not always as easy to discover as you might like! By contrast a low turnover rate would indicate a manager with a long term buy and hold view to investment.

4. Diversification

Making sure you have a good mix of funds, either directly via a model or through a fund of funds, that meet your long term needs is a key to long term success. You also need to make sure that the funds you own have a good spread of holdings. A small number of holdings may be indicative of a manager who backs his convictions while a large number may suggest the manager is going to try and match the index. Both have their place, with the former being more risky yet more likely to give you outperformance / underperformance while the later may have a lower investment risk but not outperform the market.

5. Does it do what it says on the tin?

It's important that you know what a fund can and does invest in. If you want exposure to Far Eastern equities then there is little point picking a UK corporate bond fund. But perhaps more importantly: don't judge a book by its cover. The exact index that a passive fund tracks is key. And for active funds making sure you understand the exact mandate the manager has is crucial. It wasn't long ago when the Cautious funds could hold up to 60% in Equities – and a number of investors may not think that sounds very cautious!

Also consider what impact the fund will have on your overall portfolio's asset allocation and risk. If you are picking a fund to complement others within your portfolio from the same sector, e.g. UK equities, is the new fund sufficiently different to your existing ones to offer some form of diversification? Diversification reduces a portfolio's risk – duplication does not!

6. Past performance is not a guide!

The standard risk warning that you will see on all financial literature is that "past performance is not indicative of future returns", or a variation thereof. Now this is true for a number of reasons. The research that the regulator conducted when it introduced the warning showed that there was in fact a link between past performance and the future – but only unfortunately that poor performing funds tended to be poor in future (probably due to higher costs).

7. Tax - Income or growth

Check whether the fund is focused on providing income, capital growth or a mixture of the two. This information can be found on the fund's factsheet. It's important that this matches your requirements. For example a young, high rate income tax payer may be more inclined for capital growth as they do not need

access to their funds in the short term. Income from investment funds can be reinvested but you will still be taxed on it. So a high rate income tax payer probably won't want to generate any unneeded income. Capital gains on the other hand are only taxed once you sell the investment. So make sure you also know the tax implications of your chosen fund as you may want to invest in it via a wrapper such as ISA to avoid tax altogether.

Risk warnings

All investments carry risk. These are a few of the important ones.

- The risk that you do not achieve one of your objectives.
- The risk that the growth you experience is variable.
- The risk that the buying power of your capital decreases over time.
- The risk that you might get back less than you invested.

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