Investment Newsletter

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Risk, reward and diversification

When deciding how much to invest into a particular asset class or fund within our portfolios, we have to consider various factors.

The first and most obvious one is **return**. How much money might the investment make and over what timescale?

We, of course, then need to balance that up against **risk**. Every investment carries risk of loss but the magnitude of those risks differs between asset classes and sectors. There's also a difference between a temporary loss - for example, from normal market volatility (which should be made back in time) - and a permanent loss of capital.

As well as loss of capital, there are other factors such as liquidity risk where an investor can lose access to that capital.

On top of risk and return, we also need to take into account an asset's **behaviour**. How is an investment likely to behave in a given set of circumstances? Importantly, how does that fit in with other investments in the portfolio, and does the asset provide **diversification**?

Behaviour and diversification are, if anything, even more difficult to quantify than potential risk and returns, but they are crucial to building a proper investment portfolio.

Naturally, we want all of our investments to be doing something different and not to go up and down at the same time. However, that's not always as easy as it seems. Every investment is affected in some way by the global economy, by interest rates and inflation and by the geopolitical situation. For example, every UK investment is affected by Brexit, whether it's equities, bonds or properties.

Gainful employment

Every investment has a different job to do in portfolios.

We can broadly divide the investments into two categories:

1. Risk assets – those that are supposed to provide the highest returns in the long term but can be risky in the short term.

2. Defensive assets – those that first and foremost should hold their value should the risk assets fall. That doesn't mean we don't expect a return, or that they are without risk, but this is arguably secondary to the diversifying effect on the portfolio.

The first category is relatively simple and mainly means equities. When stock markets look relatively cheap we might hold more, and when markets look more expensive we might hold less or hold more defined returns instead. However, these are assets where we must take a long-term view and ride out volatility.

The second category can, if anything, be more complicated. Whilst we want such assets to protect us should stock markets fall, there can be all sorts of catalysts for equities to dip.

For example, stock markets might fall should China experience a slowdown which could be caused by an escalation in the trade war or the US Federal Reserve putting rates up too quickly. UK commercial property should not be particularly affected by these issues and should therefore hold up well in this scenario.

However, if there was a fall in the stock market related to Brexit, then property would likely struggle too. It could fall in value and potentially prove illiquid.

Cash is king?

If risks are too great or if potential returns are too low, then we won't hesitate to move out of one of our defensive asset classes. If that means holding cash instead, even if returns are going to be low, it is worth it to ensure that asset properly diversifies our risk assets.

We would of course prefer to find assets that will provide a return and that could even go up if stock markets go down. However, at present we find it quite difficult to find assets that we think will behave this way.

In usual circumstances, fixed interest would fall into such a category. In particular, government bonds such as gilts tend to go up in value when people are worried about the world economy. In the last six months they have done extremely well, and prices have risen sharply as investors have sought the safety of government bonds. However, given the inverse relationship between prices and yields, the rise in prices has resulted in the 10-year UK government bond yields falling to about 0.8% per annum (pa). That means that if you lend your money to the government for an entire decade, you'll get paid only 0.05% pa more than current cash rates - Bank of England base rate is currently 0.75%.

Bond prices and yields move in opposite directions to each other. If the yield on gilts dropped, for example, to 0.5% pa, the price of the bond would increase. However, with yields already at very low levels it is difficult to see them falling much further.

In fact, in our view, the yield on gilts is more likely to be higher in two years' time than lower, meaning prices are more likely to fall. Even the low risk of gilts does not justify the current potential return.

Things are slightly different when we look at commercial property funds which we still think could provide an income yield of somewhere in the region of 3.5% to 4% pa, far greater than cash. This is clearly more attractive but the risks of investing in this asset class are somewhat greater, particularly at present.

Property is, of course, impacted by Brexit-related uncertainty which is leading to a shortage of potential buyers for many commercial buildings. There is also a large cloud hanging over the retail property sector given the issues with certain retailers and the shift to online shopping.

Finally, there is increased regulatory scrutiny over illiquid assets, particularly in light of the recent well publicised issues surrounding the Woodford Equity Income fund. To hear our Investment Analyst, Neal Foundly's take on the situation **click here to read his blog** or **here to watch the video**.

In our view, the risks have risen not just of losing money but of losing access to money in the property sector. As a result, we've recently decided to reduce exposure to this sector.

However, given our current feelings on fixed interest, at least part of this is likely to remain in cash for the short term.

As well as guaranteeing it won't lose money in the short term, holding cash also gives us the opportunity to act quickly and take advantage of any opportunities that arise. Any increased cash position is likely to be temporary, and if one of the main asset classes falls in value or if risks recede, then we will look to deploy the cash immediately.

Volatility means opportunity

We were recently given an opportunity to use volatility to our advantage.

On 3 June, the FTSE 100 fell to one of our pre-defined trigger points of 7,100 after Donald Trump threatened Mexico with tariffs. We used this as an opportunity to switch some funds out of low-risk assets and purchase a FTSE index tracking fund in most of our portfolios.

Just over a week later, on 11 June, we were able to sell this at a gain of around 4.4% depending on the portfolio, after Trump announced a deal with Mexico.

This ability to react quickly is vital in the current economic and political climate.

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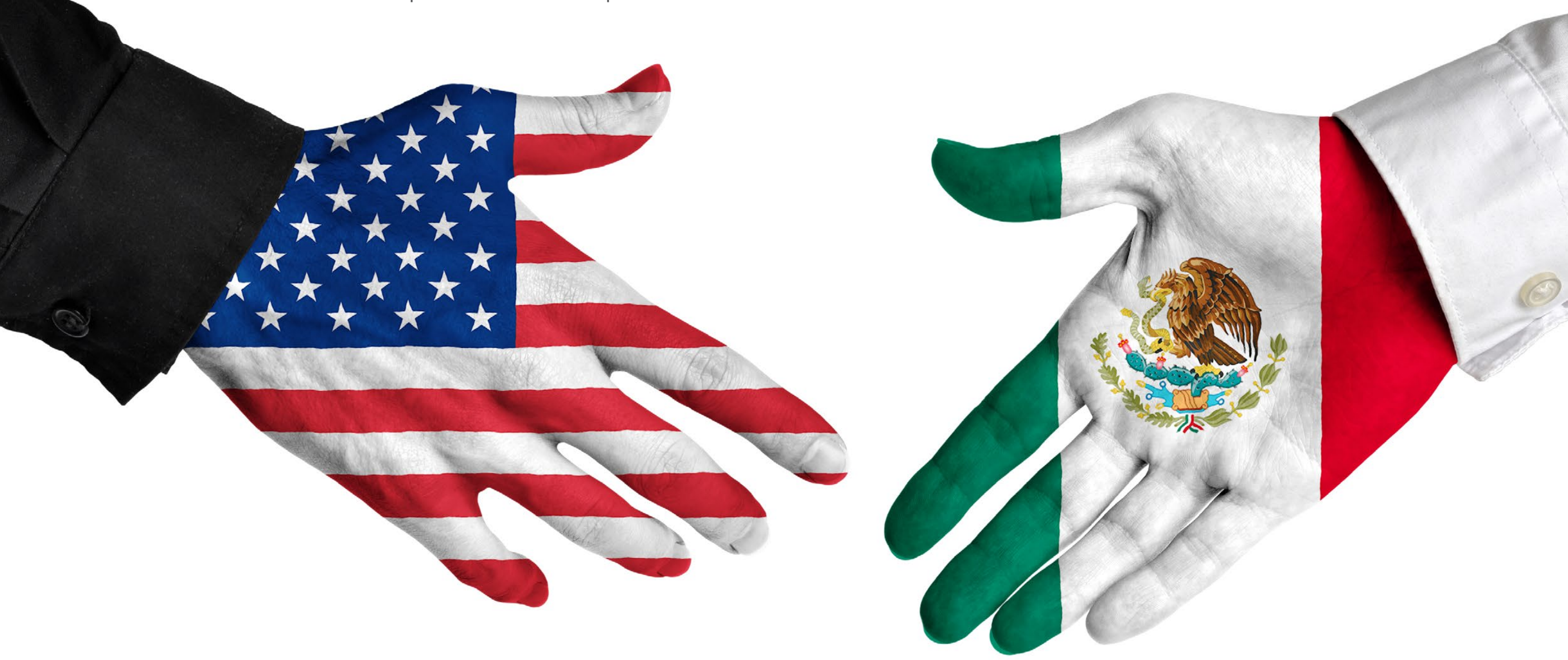

General economic overview

Although it is still growing, the global economy seems to be slowing down with manufacturing in particular finding things difficult. This is partly due to where we are in the economic cycle, but it has also been affected by Trump's trade wars and use of tariffs.

In the UK, the economy continues to be hit by political uncertainty surrounding Brexit and the identity of the next prime minister.

The market is expecting the US Federal Reserve to cut rates at least twice this year, whilst the prospect of the Bank of England putting rates up still appears remote. The European Central Bank may carry out further quantitative easing should the economic slowdown continue.

Equity markets

Some parts of the global market look relatively expensive given the current economic outlook. China, Japan and the UK look best value in our view, but each has additional risks associated. We are cautiously optimistic about stock markets but think it's important to be selective.

Fixed interest

With interest rate hikes apparently on hold, it has been a good environment for bonds. Default rates on corporate bonds remain low. However, yields are already at relatively low levels and so it is difficult to see this rally continuing for much longer and returns may be hard to come by.

Commercial property

Commercial property has been hard hit by Brexit-related uncertainty with very few transactions taking place as investors wait to see what happens. Retail properties have been hard hit by a downturn in this area, which is partially driven by the shift to online purchases. We have reduced exposure and remain very selective in our choice of funds.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest, property and traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.
