NEWSLETTER – NEWSLETTER

Diversifying Investments

The Financial Services Authority is in the process of re-defining the role of the independent financial adviser and distinguishing this from the role of the financial product salesman.

For an adviser to qualify to be described as independent, he or she will as from 2012 need to be totally fee-based and prohibited from receiving commission from the providers of financial products, and to have attained specified advanced qualifications.

In addition, IFAs will need to be able to advise on a variety of retail investment products beyond the standard packaged products sold by banks and insurance companies. These other products include 'structured' products (which incorporate financial options), Investment Trusts and unregulated investment schemes. In many cases such products may not be suitable for clients, but the IFA will need to be sufficiently familiar with them to be able to recommend them where appropriate.

The announcement of these changes provides an appropriate opportunity to review the types of investment which, according to the Financial Times, "no portfolio should be without" if it is to achieve the full benefits of diversification.

Developed world equities

UK, US and European equities are often regarded as the core element in a long-term growth portfolio, though over the past decade they have been out-performed by UK and US Government securities. Exposure to equities should usually be reduced in the years before capital is needed.

Emerging market equities

Shares in companies based or operating in the less developed markets tend to be more volatile than shares in the developed markets. The leading emerging markets are Brazil, Russia, India and China (the 'BRIC' countries), though commentators are suggesting that Russia's debt problems should disqualify it from inclusion in the elite group.

Holding a combination of developed and emerging markets funds has been found to increase returns and reduce risk, though no markets proved to be immune from the credit crunch.

Government bonds

Government bonds offer a fixed income over a defined term and the guaranteed return of capital on maturity, and they sit well alongside equities in a portfolio because their prices are influenced by different factors.

Rising interest rates and inflation are the main influence and will undermine the capital value of all bonds except the index-linked variety, which guarantee a return in excess of the rate of inflation.

Corporate bonds

Whereas Government bonds are guaranteed by the Government, the return offered by funds invested in corporate bonds depends on the financial strength of the company issuing the bonds. Consequently, both the risk and the returns are higher.

Commodities

Most investors obtain exposure to commodities through natural resources funds investing primarily in oil and mining shares, and values are driven mainly by the level of economic activity. Consequently, commodity funds tend to follow the movement in equity prices – particularly emerging markets equities, because this is where most of the natural resources are to be found.

However, it is also possible to invest in a wide range of commodities – including agricultural commodities - through Exchange Traded Commodities, which reflect an appropriate market index.

Gold

Gold differs from other commodities in that it has traditionally been regarded as a hedge against inflation and a safe haven from stock markets in times of financial crisis.

Again, access to gold can be obtained either via funds investing in gold mining shares or via Exchange Traded Commodities which are backed by physical gold.

Property

In terms of the returns available and the level of security provided, commercial property is often compared to corporate bonds; but whereas corporate bond values are affected by interest rates and inflation, property values, like commodity values, are affected mainly by levels of economic activity.

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Property investment can be made through property funds, investing in property shares, or Real Estate Investment Trusts (REITS) which invest in physical property. Clearly the values of property funds will follow those of other shares more closely than REITS and may therefore be less valuable as a diversifier.

Unlike most of the other investments discussed, property is a very illiquid investment and for this reason some funds may impose "lock-ins" when markets are falling.

Hedge funds

There are various different types of hedge fund, with varying degrees of risk and return attached, but the most straightforward is the long-short fund, whose managers are able both to hold shares they like and to sell "short" shares which they do not like, in expectation of being able to buy them back at a lower price in the future.

Some funds which do not describe themselves as hedge funds also invest both long and short.

Hedge funds are regarded as a good diversifier of risk, but the greater flexibility provided to the manager makes the performance of the fund even more dependent on the manager's skills.

Conclusion

Apart from during a few exceptional so called 'black swan' events, for example the 'credit crunch', the benefit of diversification within a portfolio of assets that are non-correlated cannot be overstated.

Crucially, diversification makes it possible to manage risk and reduce volatility.

August 2009

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