EQInsight

What to expect when you are investing

Whether you are investing money for the first time or have a wealth of experience it is helpful to go back to basics from time to time.

Investments are only ever a means to an end – they exist to help you achieve your goals in life. Typically, people invest money because they want to obtain or maintain financial freedom for the future.

There will be times when returns are high, but there will also be times when your portfolio falls in value. These are short term changes and it is important to understand from the start that you will not receive the same return every year.

Over the long term, history shows that investment portfolios (e.g. equities and bonds) tend to increase in value. We will work with you in good times and hard times as your trusted adviser. We will remind you of why you are investing and help you keep your long-term goals in mind.

In this guide we will explain what to expect when you are investing.

This guide provides general information about investing and is not a personal recommendation. The value of investments and the income derived from them can go down as well as up, so you could get back less than you originally invested.

What is investment risk?

When we invest money, we are trading certainty for uncertainty in exchange for a potentially larger financial reward. We call this exchange of certainty for uncertainty taking investment risk.

The chart below shows how this might play out over the long term. As we move from left to right we can see the effect of taking more investment risk. This suggests the more investment risk you take, the higher the potential long-term return. However, the range of returns, particularly in the short term, will be larger as well.

Why take risk?

When we deposit money in the bank we can be confident that we will get our money back in full. In the UK this is guaranteed (up to a certain amount) by the Financial Services Compensation Scheme. We also receive a certain, but relatively small financial reward in the form of interest.

When we invest money the returns are uncertain and the amount of money we get back can change from day to day. The more uncertainty we are prepared to take, the greater the potential financial reward. But our investments may also fall in value, so there is a chance that we could lose money and get back less than we put in.

Portfolio returns over 20 years

How much risk should I take?

1 What's your comfort level?

If we are taking so much risk with our money that it keeps us up at night something is wrong. Our investments are there to serve us – not to make us anxious! Equally, some people have a preference to make their money work hard and would be disappointed if their investments were not exposed to a relatively high level of risk. It's important to first understand how much investment risk you would feel comfortable taking.

To help work this out we have designed a multiple-choice questionnaire for you to complete. This asks questions about how you weigh up risk and reward, certainty and uncertainty. We also want to understand how you have felt about previous financial decisions. We use your responses to make an initial assessment of your willingness to take risk. You might hear this described as your *attitude to risk*.

2 What can you afford?

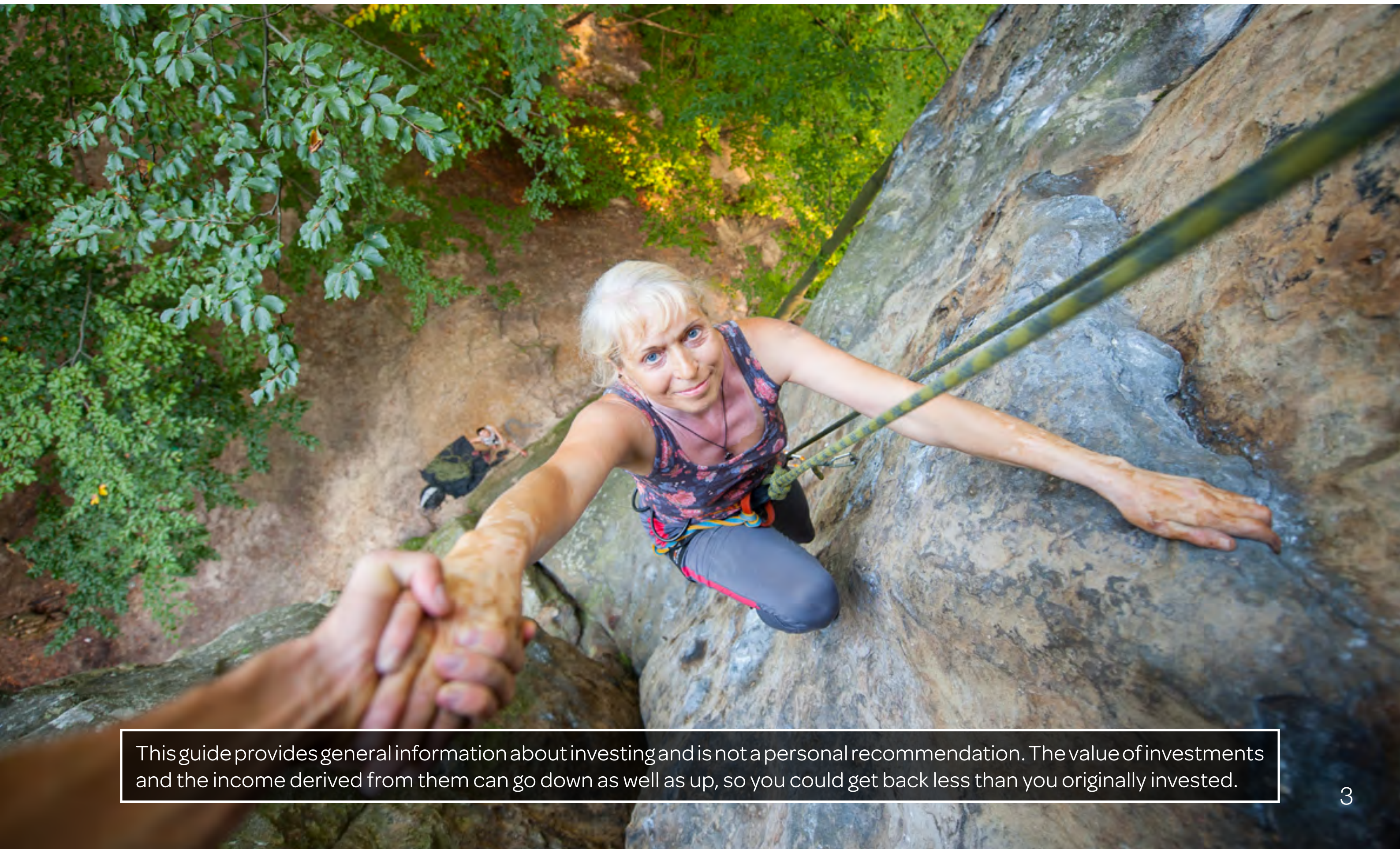
When we invest, we generally do so to obtain or maintain our financial freedom. Having identified your objectives and understood your financial situation we need to work out what to do. We will work out what financial return you need to achieve your objectives and from there ascertain how much investment risk you may need to take to get there.

But what happens if the risk doesn't pay off? What happens if markets are falling at the time you need to access your money? We will look at the financial impact of a potential market loss and stress test your plan to see how much risk you can afford to take. You might hear this described as your *capacity for loss*.

3 Coming to a balanced decision

Most people will need to take some investment risk to achieve their objectives and will have the financial capacity for loss to do so. However, if we take more risk than we are comfortable with then we might worry about markets so much that we cannot enjoy life in the present.

Coming to a balanced decision on how much risk to take is a collaborative process. We will use our experience and understanding to recommend what we feel is most suitable for you. However, at the end of the day this is your money being invested – not ours – and you must be happy with the strategy.



How risky are my investments?

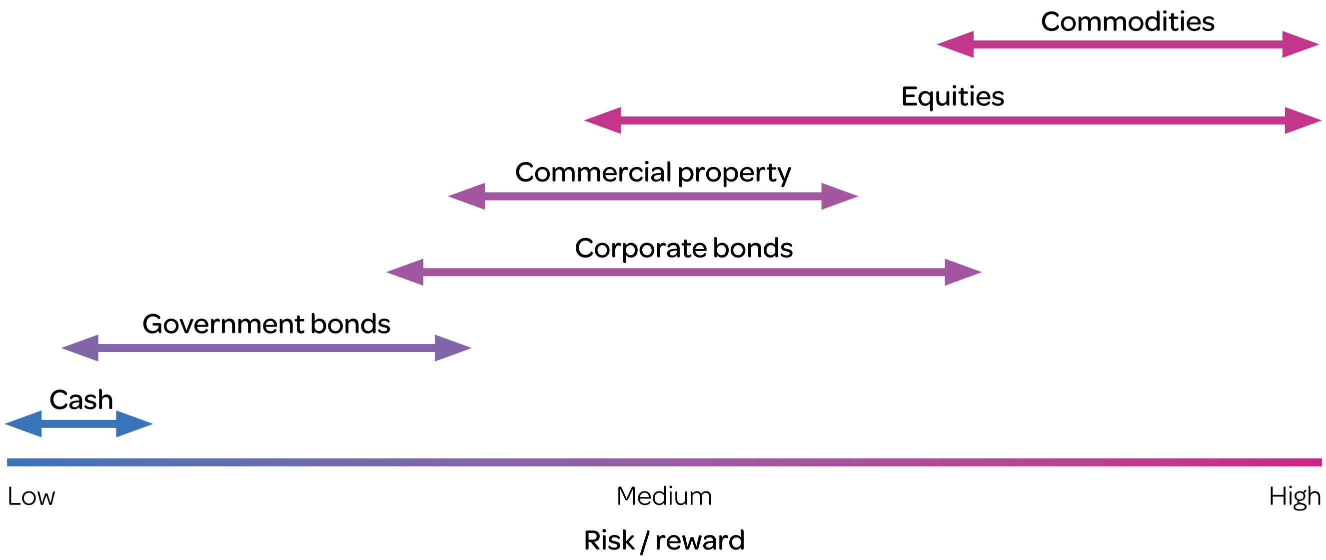
Different types of investment behave quite differently, entailing more or less risk. Whilst lessons from the past might give an indication of how they might behave, nobody can predict the future with certainty.

Nevertheless, investments that share similar characteristics (e.g. equities) form groups which tend to react similarly to events. These are called *asset classes*. Different asset classes might react differently to the same stimulus.

We will recommend a portfolio to hold a diverse range of asset classes, based on the amount of risk you agree you wish to take.

On page 2 we saw that taking more investment risk can result in potentially higher returns. In the chart below, asset classes towards the right tend to experience more fluctuation in value than those on the left. This is not always the case: for example some bonds can be riskier than some equities.

An investment portfolio's overall risk profile is mainly determined by its equity portion. An adventurous portfolio is likely to have more exposure to equities than a cautious one. Cautious portfolios are still likely to have some equities in them, but these tend to be invested more in larger companies and in more stable countries.



Spreading your risk

Investing in different asset classes helps to spread your investment risk. Having a broad mix of investments therefore follows the simple principle of 'not putting all your eggs in one basket'.

Another way in which we spread your investment risk is to use investment funds rather than investing directly in companies. This results in much greater diversification, allowing you to invest in hundreds of companies rather than a handful of individual stocks.

This is the approach that we take at EQ Investors.

Why we invest through funds

At EQ we believe that using funds is a much smarter approach to building portfolios than ‘stockpicking’, or trying to select individual shares. Funds offer several advantages:

There’s a world of opportunity out there

Our investment team is based here in the UK but we invest globally. We need the reach to assess far flung opportunities, and funds provide just that. Prospects can change from day to day in the light of fresh news, so it makes sense to tap into the deep expertise of specialist fund managers who focus on a specific sector or base themselves in a specific region.

Funds are a great way to diversify your investments

If we were picking individual stocks, our clients’ portfolios might hold shares in 30-40 companies, whereas by investing through funds you are likely to have exposure to 700-800 individual holdings. This hugely reduces the risk of significant losses if an individual company suffers an unexpected fall in share price.

We can build deep partnerships with selected active fund managers

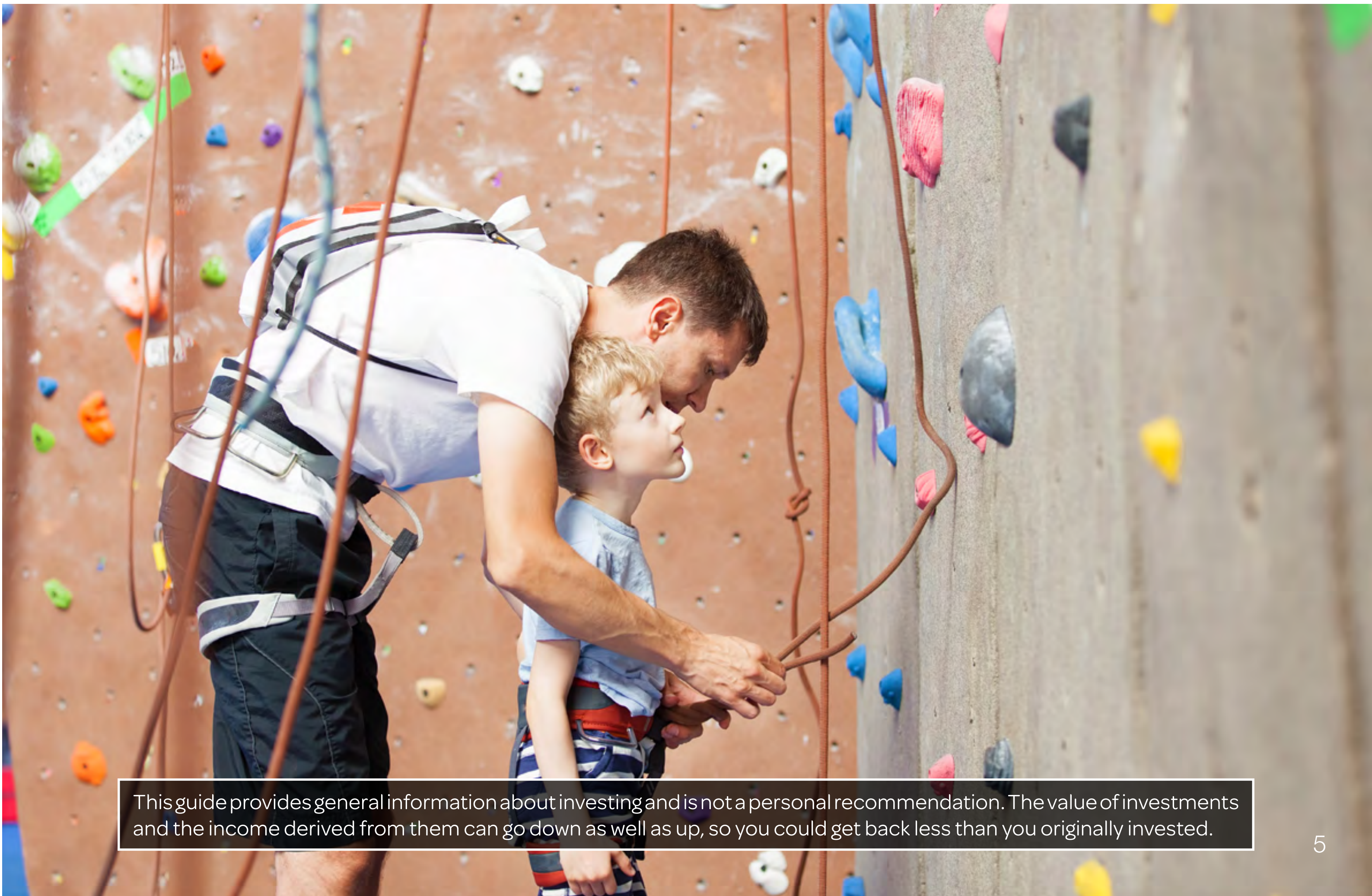
We are extremely rigorous in selecting the fund managers we work with. With active funds we can leverage the research teams of specialist fund managers – we typically use these to target specific investment opportunities. This level of management comes at a price, but we may assess that this is worth paying for potentially higher returns.

We also take advantage of cheaper, passive funds

Passive funds take a different approach, usually tracking the performance of an index (such as the FTSE 100) by simply matching the contents and proportions of the index. This makes passive funds cheaper than their active rivals, and in some cases we may see this as offering the best value for money as a way to gain broad market exposure.

Funds are more tax efficient

When a fund manager sells shares at a profit in the portfolio this does not trigger a tax liability for holders.



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Tell me more about these asset classes

1 Equities

Equities are owning a stake (or a share) in the future profits of a company. Investors are rewarded with dividends if the company makes a profit and decides to distribute it. If the value of the company increases, then investors will also make a profit when they sell their shares.

There are many ways to value a company such as adding up what they own (e.g. stock) and deducting liabilities (e.g. loans). When we are investing the value is simply the price people are prepared to buy or sell at. The price changes based on how well people think that the company is or is likely to do.

Not all equities are created equal. In general:

- Smaller companies tend to be riskier than larger ones.
- Developed markets (e.g. UK, US, Europe) tend to be less risky than emerging markets (e.g. China, India, Nigeria).

If you are investing in a company that is based (or generates significant revenue) overseas, then changing currency exchange rates can present an additional risk.

2 Bonds

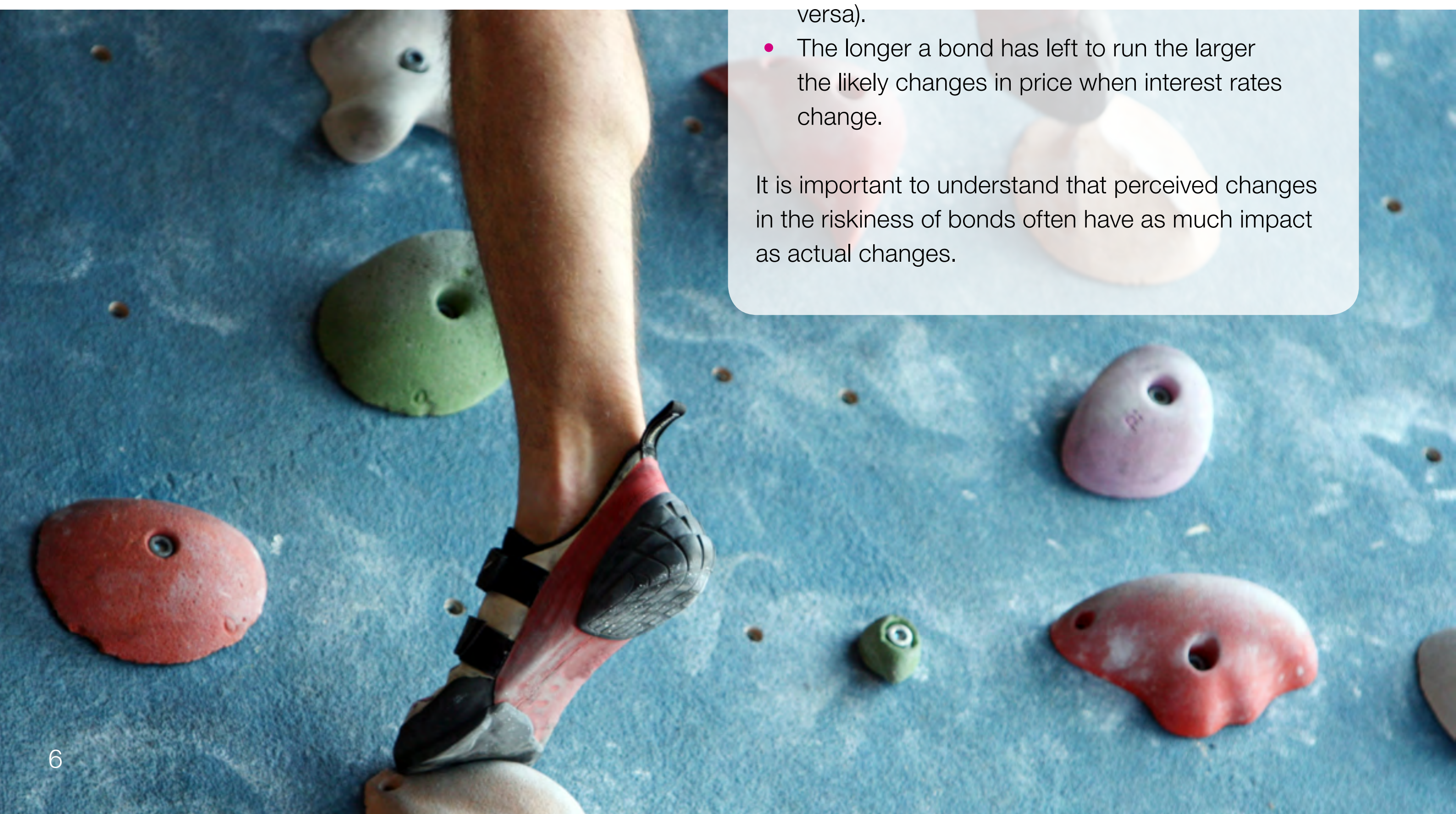
Bonds are simply money lent to companies or governments in return for interest payments. The greater the risk of the loan, the higher the interest rate. Interest payment amounts are set at the start of the bond, and the amount lent is repaid at the end.

Government bonds (Gilts) tend to be lower risk than corporate bonds because (in general) governments are less likely to go bankrupt than companies. But while corporate bonds tend to be higher risk, just like governments, some companies are more stable than others.

This picture quickly becomes more complex as perceived risks can change over time:

- If risks increase, investors will demand a higher rate of return from bonds.
- As they tend not to hold the same bond from start to finish, investors compensate for this by adjusting the price at which they are willing to buy or sell bonds.
- When central banks (like the Bank of England) change interest rates, this affects the return that investors require from bonds.
- If interest rates go up, then the interest required from the bond will go up and the price at which they are bought will generally go down (and vice versa).
- The longer a bond has left to run the larger the likely changes in price when interest rates change.

It is important to understand that perceived changes in the riskiness of bonds often have as much impact as actual changes.



3 Property

Property funds invest to share in the returns related to owning buildings (rental income and changes in value). Most of the time the buildings will be commercial properties such as offices and shopping centres rather than homes.

Some funds invest directly in properties: for example, office buildings or warehouses. These funds receive rental income, and when they sell each site in the future they hope to realise a profit. The true value of the property will only be known when it is sold. They will invest in a large number of properties spread across a wide range of locations and different types of property.

Other property funds invest in property companies. Rather than owning physical properties, they own shares in companies that own (or manage) physical properties. Whilst you might be spreading your investment across a potentially larger number of properties, these investments are equities. There will be a difference between the value other investors will pay for the shares and the underlying value of the properties that the companies own. This can produce a higher return (especially if this difference changes), but they are a higher risk way of investing in property.

4 Commodities

Commodities are an investment in the changing value of a natural resource (such as copper or gold). The investment might be in the value of the resource or in companies involved in the extraction or supply of it. The value of these investments is very strongly driven by sentiment (even more so than the other asset classes) and expectations for the future.

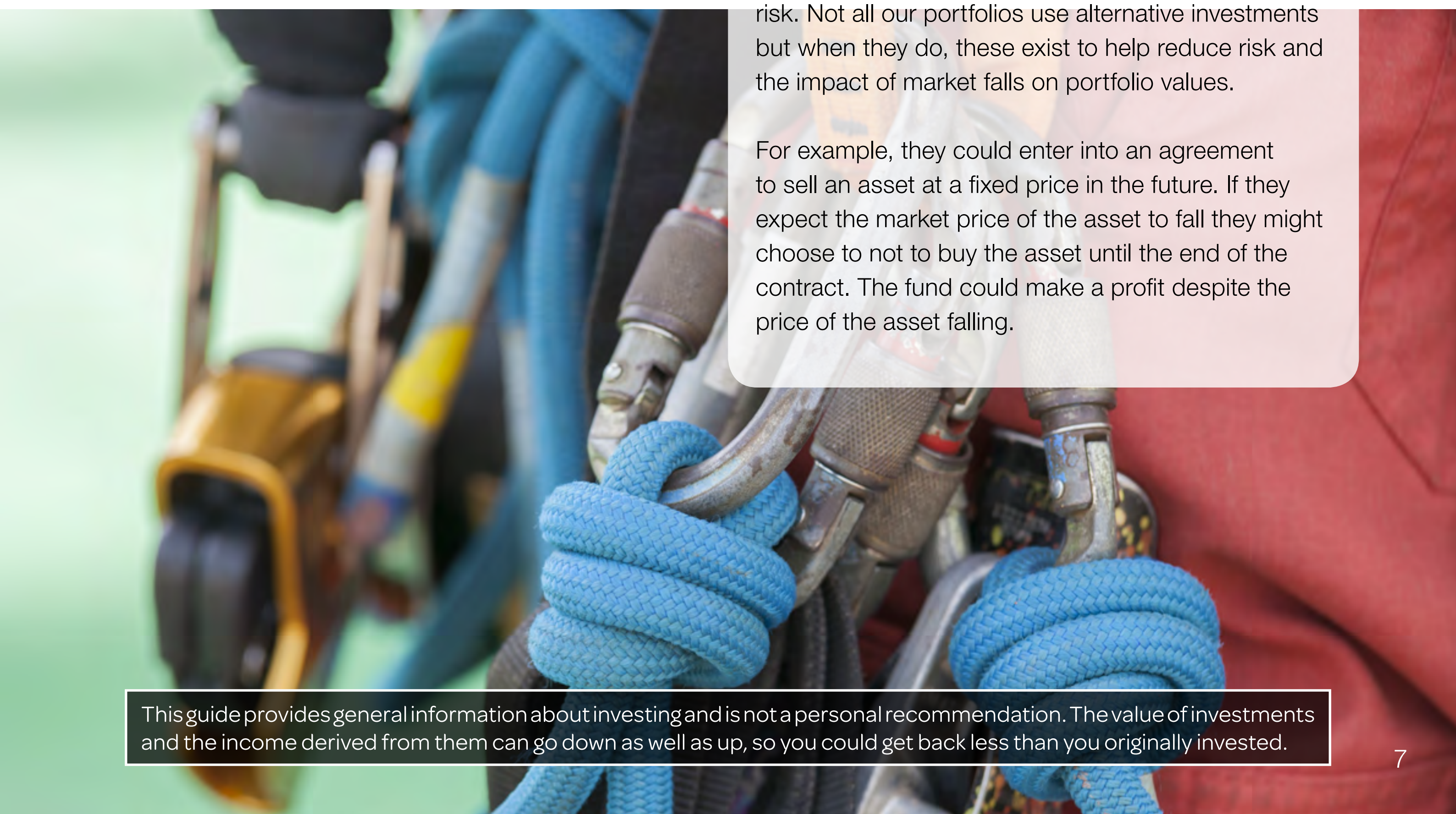
This can be a useful asset class but is only likely to form a small part of your portfolio. Most of the buying and selling of commodity-based investments is highly speculative and this results in significant changes in value over short periods of time.

5 Alternatives

Alternative Investments is a broad category which essentially holds investments that don't fit in any of the other asset classes. Alternative investments can invest in all of the usual asset classes. However, they can also use strategies with the potential to also make money in falling markets. As a result, they tend to behave differently to other asset classes and can be used to help manage risk.

However, not all alternative investments are the same and some are more speculative, taking a much higher risk. Not all our portfolios use alternative investments but when they do, these exist to help reduce risk and the impact of market falls on portfolio values.

For example, they could enter into an agreement to sell an asset at a fixed price in the future. If they expect the market price of the asset to fall they might choose to not to buy the asset until the end of the contract. The fund could make a profit despite the price of the asset falling.



Bringing it all together

Investing for the future makes sense as a way to achieve your financial goals, enabling you to live the life you want. Whilst some people relish the challenge of managing their money themselves, most have other calls on their time and energy.

Our highly qualified investment team spends all day every day working on our clients' portfolios. Part of the team focuses on researching investment markets and choosing the right mix of asset classes for each level of risk. Other members of the team concentrate on finding the right funds to invest in and holding the fund managers to account. Our investment managers harness this to build your portfolio, so you can focus on what is really important to you.

Your EQ adviser will explain exactly what this means for you, keeping track of progress and keeping you up to date. Whether you are working with one of our financial planners or directly with our investment team, we are here to help you use your wealth to achieve your goals in life.

Please remember that past performance is not a guide to future returns. The value of investments and income derived from them can fall as well as rise, and you may get back less than you originally invested.

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