Investment Basics

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As one of the largest asset management firms in the world, we have drawn upon our experience and resources to put together this short guide to the basics of investing. Our hope is that it will help explain how bond and equity investing works, and go on to explore some key concepts such as diversification, and the benefits of investing in mutual funds. Our aim in writing this guide is to provide investors with an understanding of the investment basics, but we would always recommend that the first stage of making an investment is to consult an authorised financial adviser.

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Understanding equities

By investing in the stock market, you're buying shares in a company (known as equities) in the hope that the company will perform well, and the share price will go up. Of course, it can go down as well, which is the extra risk you take. Stockmarket investments should be viewed over the medium to long-term, which is normally considered to be at least five years.

Equities are considered to be among the riskier types of investment as their prices fluctuate more than cash or bonds. However equities also offer greater growth potential and over the long term, historically equities have outperformed these other asset classes. Investors should remember, however, that past performance is no guide to the future.

Equity prices are driven by market sentiment and the laws of supply and demand – if a company is doing well then more people will want to buy into a slice of the action and hence the price rises. But it works both ways. If a company is expected to have a great year and produce bumper profits, and it only ends up having an average year, its share price may fall to reflect that disappointment. Of course in reality equity prices are also affected by a wide variety of other factors such as political and economic events.

It's possible to invest in equities directly, but many people choose a mutual fund instead, such as a unit trust or an open ended investment company, where their money is pooled with that of other investors. A professional fund manager will then use that money to invest in a selection of companies. If they are significant shareholders in a company, the manager may meet with management to ensure the firm is well run. They also collect any dividends and share them out with all the fund's investors. The benefits of mutual funds are explained in greater detail later in this brochure.

“ For those investors who want their money to work harder, and are prepared to accept some risk to their capital, the stock market can offer greater potential for reward.”

> "Fixed income securities, or bonds, are a useful addition to portfolios offering many diverse opportunities for investors."

What happens to bonds when interest rates rise?

Fig 1

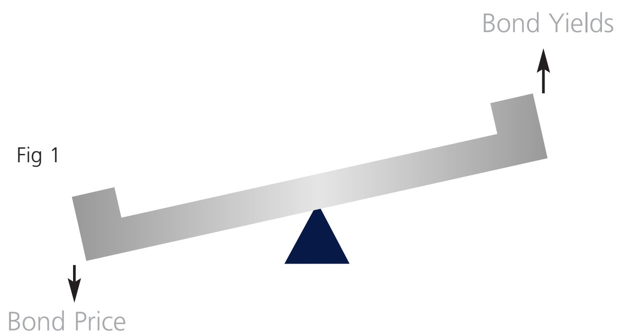
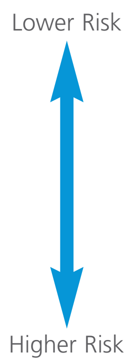


Fig 2



How are bonds graded?

Moody's	S&P	Definition	Known as
Aaa	AAA	Highest rating available	Investment grade bonds
Aa	AA	Very high quality	
A	A	high quality	
Baa	BBB	Minimum investment grade	Known as
Ba	BB	Low grade	Non-investment grade or
B	B	Very speculative	high yield bonds
Caa	CCC	Substantial risk	
Ca	CC	Very poor quality	
C	D	Imminent default or in default	

Understanding bonds

Bonds are considered less risky than equities. They are loans issued by borrowers – governments, banks and corporations – who need funding for varying periods of time. In return the issuer pays back a series of regular interest payments (coupons), as well as the full repayment of the initial amount at maturity. So a five-year bond, with a nominal value of £1,000, and coupons at 5% a year, will pay back £50 each year, as well as the nominal value of £1,000 in year five.

Most bonds are listed and can be freely traded on the market. The resulting price fluctuations and the varying degree of risk between different types of bonds can make bond investing as challenging and rewarding as equities. A convenient way of investing in bonds is through a bond fund, where an investor's money is combined with that of other investors to purchase a number of bonds. The managers of these funds are unlikely to buy bonds and hold them until they mature. Rather, they use their expertise to trade bonds, buying them when they are cheap and selling them when they are expensive to try and gain a better overall rate of return. Such portfolios also further diversify an investor's risk from company, geographical or political risk.

Broadly bonds fit into two categories – government bonds and corporate bonds. Government bonds (gilts in the UK, treasuries in the US) tend to be considered the safest form of fixed income investment, unless issued from financially unstable countries, as the chance of governments failing to pay is rare when compared to a company failure. However, with that stability comes a lower level of interest. Corporate bonds are issued by companies and tend to be more risky than government bonds as companies are more likely to default on payments. The riskier the company, the higher the reward they need to provide investors and this is reflected in higher yields.

Bonds are divided into two types – investment grade bonds (rated AAA to BBB) and high yield bonds (rated BB downwards) – by leading ratings agencies such as Standard & Poor's (S&P) and Moody's (see Fig 1). These ratings offer an indication of the ability of a company to meet its obligations. Investment grade bonds tend to be issued by developed world governments or large blue chip companies and are considered lower risk investments, while high yield bonds are usually issued by developing world governments and smaller or less stable companies, which as with gilts determines the bond's price. The higher the risk, the higher the return. At the bottom end are junk bonds, with a rating of CCC or lower.

Inflation over time can erode the value of bonds. Also, bond yields are usually inversely related to interest rates, so if interest rates increase, the price of the bond will fall as they become less attractive (see Fig 2). Because of the varying factors that influence the bond price, the range of duration (sensitivity to interest rate movements) and rating of bonds on offer, the asset class is far from a 'fixed income' and can be much more than just an alternative to equities.

The importance of diversification

Diversification means spreading risk over a range of asset classes, such as equities and bonds so an investor's portfolio is not too adversely affected by movements in any one investment. Financial markets are affected by factors such as global economic events, wars and interest rate movements. These events can influence markets in different ways, so as one asset suffers another might prosper. Having a blend of different investments such as cash, bonds and equities within portfolios can help to smooth investment returns and lower the overall volatility, and asset classes should be viewed as building blocks to a well diversified portfolio.

When building your portfolio your financial adviser will need to consider a number of issues with you. If you already have an equity portfolio, bonds may be a useful tool to diversify your portfolio, as the risk taken on the equity markets can be counterbalanced by the generally safer bond markets. The fixed income section of a portfolio can be further spread over government and corporate bonds. The former are bonds issued by governments, which tend to be fairly safe if issued by economically stable countries. The latter are smaller, unproven companies, which are more risky but offer investors a higher rate of return on their bonds. However, both types allow the investor to balance the relative security of the bond market with the more volatile returns of the equity market.

Equity investment, meanwhile, offers exposure to a wide range of markets depending on an investor's appetite for risk. Emerging markets equities, for example, can give investors soaring returns, but can be extremely volatile compared to other equities. However, heavy investment in just US or UK equities, as seen by the stock market crash in 2000, shows that no one market is safe from volatility. Indeed, within equities there are benefits in diversifying your holdings across a wide range of countries, gaining access not only to different companies, but also different economies with varying growth prospects.

Although investors have traditionally spread their portfolio between bonds and equities, other asset classes are becoming available. Alternatives such as property and private equity allow investors to diversify further. Put together, this can further smooth out the volatility and increase the chance of long-term stable returns – the desired outcome for most investors. However, before making your investment, please seek advice from an authorised financial adviser.

"Diversification can be easily summed up in one well-known phrase – don't put all your eggs in one basket. The table below highlights the difference in returns between major investment regions and illustrates the fact that by achieving a mix of investments investors will leave themselves less exposed to the volatility of a single investment region."

Regional market performance over last 10 years to end of December, 2006

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Japan	-24.26%	-25.18%	6.50%	81.69%	-27.44%	-27.47%	-17.64%	24.68%	8.56%	41.02%	-10.49%
UK	14.84%	22.76%	13.19%	23.58%	-6.32%	-13.71%	-23.13%	19.98%	12.09%	21.24%	16.01%
US	11.56%	38.70%	27.16%	24.96%	-1.94%	-9.56%	-29.58%	15.73%	3.38%	17.34%	1.56%
Europe	9.06%	30.13%	31.54%	19.86%	1.27%	-20.05%	-27.04%	29.74%	13.83%	24.08%	20.13%
Global Bonds	-4.82%	7.94%	12.45%	-2.10%	11.30%	4.26%	5.33%	1.18%	1.88%	6.83%	-6.47%
Asia	-0.16%	-37.92%	-8.81%	70.00%	-30.12%	-1.29%	-17.13%	32.18%	9.76%	37.76%	17.30%

S&P Micropal, mid to mid with net income reinvested, in UK pound sterling. UK represented by FTSE All Share index, Europe by FTSE Europe ex-UK Index, US by S&P 500 index, US Smaller Companies by Russell 2000 index, Japan by Japan TSE (First Section) index, Asia by MSCI AC Asia ex-Japan index, World by FTSE World index and Global Bonds by Lehman Global Aggregate Bond index.

“ When investors set up a portfolio it is important to realise that there is no one size fits all strategy for success. It’s not just about diversifying a portfolio among different forms of investment; it’s about deciding how much to put into each asset class to best fit the investor’s profile. You should consult your financial adviser for further details about how to go about this.”

Understanding risk

Very high risk
- Emerging market equity funds
- Single-country overseas equity funds

High risk
- Emerging market bond funds
- Single-sector equity funds
- Smaller companies funds

Medium risk
- Overseas core equity funds

Low to Medium risk
- Domestic core equity funds
- High-yield corporate bond funds

Low risk
- Investment-grade corporate bond funds
- UK government bind funds

Very low risk
- Liquidity funds and cash

Placing 100% of a portfolio into cash will guarantee no money is lost, yet very little return will be made on the capital. Conversely, ploughing the whole portfolio into emerging markets equities may offer soaring returns, but capital could be at serious risk.

It's important to understand investment risk so investors can tailor their portfolio to suit. Investment risk, however, is not simply the risk of losing all or part of an investment. It is often measured in statistical terms as the variability of returns around an expected level, rather than just the risk of loss. The expected level of return is known as 'average return', and the variability of returns is measured as the 'standard deviation' of returns. Investment risk comes in the form of unpredictability and uncertainty as share prices, interest rates, inflation, and movements in currency markets, can all harbour an element of risk for an investor's portfolio.

If you are prepared to accept some risk how much risk will also be determined by the length of the investment period. Longer-term investment can carry a lower risk, because there is more time to recover any losses. Investors should consider less risky assets when investing for the short term.

Every investment carries an element of risk. Diversifying a portfolio across a range of assets such as equities, bonds and cash, will help smooth out the volatility across different markets and maintain a more consistent return on the investments, therefore reducing the overall risk.

“ Understanding the risk is a central plank of a sound investment strategy. There is an inherent trade-off between investment risk and return, so in general terms the riskier the asset, the higher the potential return.”

“Mutual funds are an important tool for building portfolios and an easy way for investors who do not have the time, money or knowledge to invest directly in shares, to benefit from exposure to equity markets.”

Mutual funds in more detail

Mutual funds pool money from groups of investors and invest it in a range of investments. Investors can buy shares in the funds, which represent a part of the fund's holdings and the income the fund makes.

Fund managers invest the money put into mutual funds by using professional knowledge to pick certain assets. Investors may choose mutual funds because investing directly in equities can seem daunting to the uninitiated, so knowing professional managers who will research, monitor and pick the stocks they think will perform best, is an attractive option.

Mutual funds also offer increased diversification by spreading the portfolio across a wider range of investments than generally is possible as an individual investor. Mutual funds also provide investors with more flexibility to invest in world stock markets, from the UK, US and Europe, through to Asia and emerging market countries.

For investors who don't have huge amounts of money to invest, mutual funds represent an easy way to enter the market. The ability of investors to easily redeem their shares – liquidity – is another plus point for mutual fund investing.

Choosing an appropriate investment strategy

There are several types of investment strategy used in selecting equities or bonds - the most common are growth and value investing, and large-cap and small-cap investing. Growth investing is when investors seek earnings growth and a sustained rise in share price. Investment tends to be in newer industries or smaller companies that are growing quickly. Investors looking for value investing will go for the bargains. Value investing is based on picking companies whose share price doesn't match its true worth, in the hope that the price will rise in time. Value investing takes less risk and is designed to offer a steady income through dividend payments of mostly larger companies.

Growth and value stocks also tend to outperform at different times in the economic cycle. When markets are rising growth stocks tend to do better and when markets are falling, value stocks tend to come to the fore. The most common approach by investors, is to adopt a blend of these two investment strategies. By opting for a mixture of these options investors can gain exposure to more risky high-returning stocks, while maintaining a consistent return from safer investments, therefore smoothing out volatility, reducing risk and improving long-term returns.

When determining an investment strategy, investors may also consider the difference between small- and large-cap investing. The terms refer to the market capitalisation of the company, which is simply the number of shares in a company, multiplied by the share price. Large-cap companies are larger businesses found in indices such as the S&P 500 in the US, and the FTSE 100 in the UK, whereas small-cap companies are smaller businesses, which may trade on the AIM index in the UK or the Russell 2000 in the US. Large-cap companies tend to offer investors greater certainty as there is generally lower risk of the companies going bust, and there is greater liquidity of shares. Large-caps also tend to pay out higher dividends. However, small-caps can generate higher returns for investors who are willing to take the accompanying risk, as they are less well researched. Many companies start small, so investing in small-caps might mean investing in tomorrow's large-cap, benefiting from the jump in share price.

It is important for investors to consider the length of time they plan to spend investing, as this has an impact on the investment strategy the investors should adopt. The longer the investment horizon, the greater opportunity the investor has to achieve an investment goal, therefore allowing a heavy weighting in riskier stocks. Over long periods of time, equities have always outperformed other asset classes, despite short-term fluctuations.

"There is a wide variety of different investment strategies, however, mutual equity funds can be broadly divided into growth and value."

Growth stock – Characteristics

- Expected to generate above average earnings
- Generally receive positive newsflow
- Tend to outperform when economy is booming

Value stock – Characteristics

- Solid companies trading below market prices
- Out of favour or overlooked by investors
- Tend to outperform during economic recovery

Mutual fund types

Bond and equity funds broadly tend to fall into one of four categories*

Equity Funds

General	Small	Focus	Specialist
e.g. UK balanced funds • May invest in equities or bonds or a mixture of both • Well-diversifed • Do not take big risks	e.g. Small company funds • Invest in relatively less-established companies • Ability to demonstrate rapid growth	e.g. Funds investing in limited number of stocks • Takes large position in companies • Potentially higher returns but also greater risks	e.g. Emerging markets funds • Often concentrate on one region or sector • Potentially higher returns but also greater risks

Bond Funds

Government	Corporate	Multi-Sector	Non investment grade
• Invests in bonds issued by governments of developed countries • Relatively low risk • Steady returns	• Invests in bonds issued by companies • Potentially higher returns but also greater risks	• Invests in a range of bond types including government, corporate, high yield and emerging markets • Has ability to switch between sectors • Potentially higher returns but also greater risks	• Invests in potentially higher risk asset classes, including high yield and emerging markets • Bonds rated BB and downwards by rating agencies • Potentially higher returns but also greater risks

* If you require more detailed information, please visit the Investment Management Association website, which has created a classification system of over thirty sectors, each containing funds with similar characteristics.

Important information