The Private Office
Understanding Risk

the private office

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Understanding our approach to risk

Everyone is different. Where investing is concerned, our perceptions, aspirations, needs and resources make us so. Your investment outlook is as unique as you are so before we start advising on what to do with your money, we make sure we understand you, your circumstances, objectives, and your individual 'attitude to risk'.

This document is intended to help you better understand what 'risk' can mean in the context of financial planning, and how differing types of investment solution might behave.

We will work with you to build your individual financial plan, incorporating appropriate use of the tax wrappers and planning tools available, through fact finding, risk profiling, wealth allocation, implementing and reviewing your own investment strategy.

The value of an investment and the income from it could go down as well as up. The return at the end of the investment period is not guaranteed and you may get back less than you originally invested.

Past performance is not a reliable indicator of future returns.

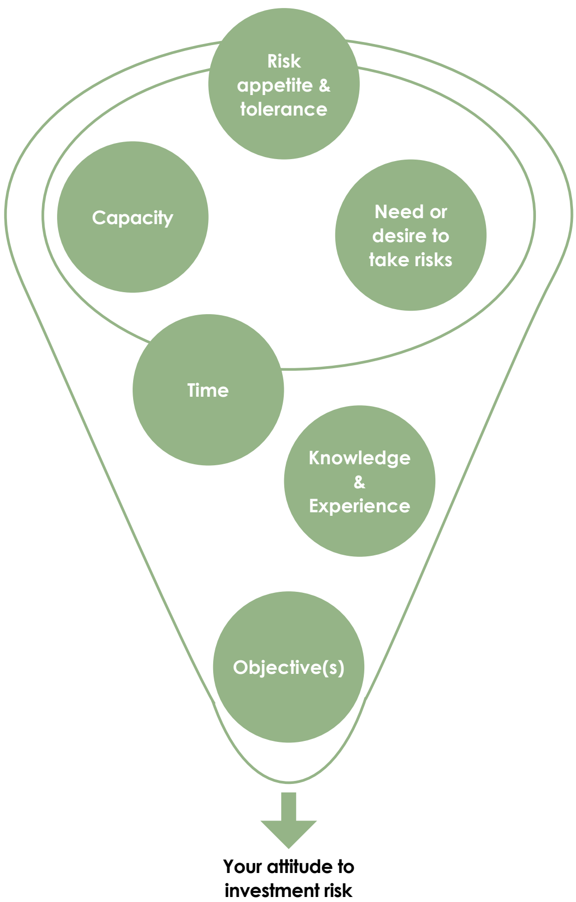
Determining your attitude to investment risk

What does risk actually mean for Investors?

Risk is a huge subject, it comes in many forms, and is something that we all have a view on. For some it means danger, discomfort and should be avoided at all costs, for others, it is an opportunity.

Some examples in the context of financial planning are:

- Concentration risk
- Currency exchange rates
- Inflation
- Interest rates
- Legislation & regulation
- Liquidity or accessibility risk
- Market volatility
- Politics
- Rates of return and fluctuations.



Some of these can be controlled or mitigated, others cannot. Our role is to build an investment portfolio with greater or lesser degrees of risk, in accordance with your objectives, tolerance, capacity for loss and overall view on risk.

So, what is meant by 'attitude to risk' and how is it established?

Your personal risk profile is not only how you feel about taking risks and your willingness to accept it, but also your financial capacity to withstand it, and your need to take risk (and at what level) to potentially achieve your objectives.

Our primary task, when helping determine your risk profile, is to really understand you, your financial objectives, and what you are trying to achieve from your investments.

These are summarised in the graphic below:

Risk, appetite & tolerance: the emotional factors. What are your instinctive thoughts and feelings about risk, and what would keep you awake at night? This is almost completely subjective, and to help both clients and advisers understand and challenge these views, we will often use a risk tolerance profiling tool, or questionnaire to aid our discussions.

Need or desire to take risks: this is the importance of a good discussion and good planning. Not everyone needs to take risks to achieve their objectives, but some may still chose to. Some risks may be quantifiable where a specific rate of return is required, others will be more aspirational.

Your capacity for loss: this is your financial ability to withstand investment losses without impacting your standard of living, otherwise known as affordability. We will look at the asset base and income streams you have, and determine your capacity to accept investment risk in the context of your overall financial plan.

Knowledge & experience: of financial services, products and transactions, how previous experiences have made you feel, and what drove you to make the investment choices and decisions you have made in the past?

Objectives(s): it is not unusual for clients to have a number of different financial objectives, and differing attitudes to risk depending on what they are trying to achieve, and some may even be quantifiable such as building a fund for a house purchase or university fees.

Time: how long can the monies be invested? Generally the longer the better, particularly where you are looking to grow your capital. Investing indefinitely, or for 10 years plus, potentially offers more ability to withstand market volatility, accept higher risks and an opportunity to exit strategically. Where investments are for a shorter period, or with a defined term for when the funds are required, a different approach to investing will be needed.

Our approach to portfolio construction

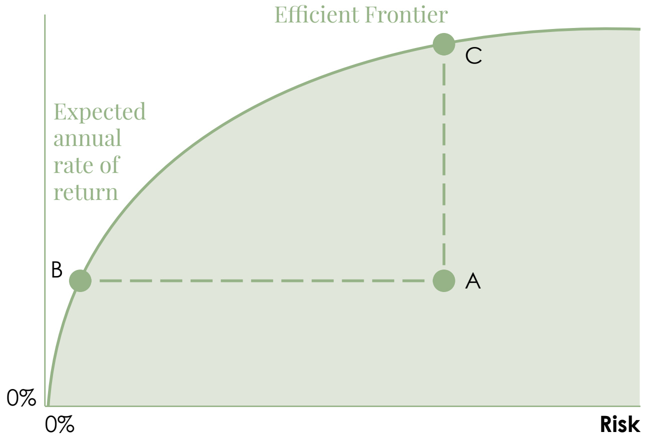
Risk profiling is equally important for clients with one, or a multitude of financial objectives, and for those with simple or more complex planning requirements.

The solution(s) we recommend will depend on this, and a number of other considerations, such as how much involvement you wish to have in the day-to-day decision making about your investment holdings, as well as any specific expectations you may have.

The 'Risk-Efficient' portfolio

As noted above, risk and reward are inextricably linked, and for most, risk in the context of financial planning is the extent to which investments make or lose money. The risk we are prepared to accept will often vary in accordance with our objective (i.e. the purpose for which we are investing), and is inherent whether we save or invest.

The pivotal issue is whether the amount of risk taken, and with which we are comfortable, gives the greatest opportunity to maximise returns. Many investors may not be aware whether their portfolio is in the ideal position to maximise returns or not; and as the graph below illustrates, the difference between an 'efficient' and an 'inefficient' portfolio can be much greater than expected:



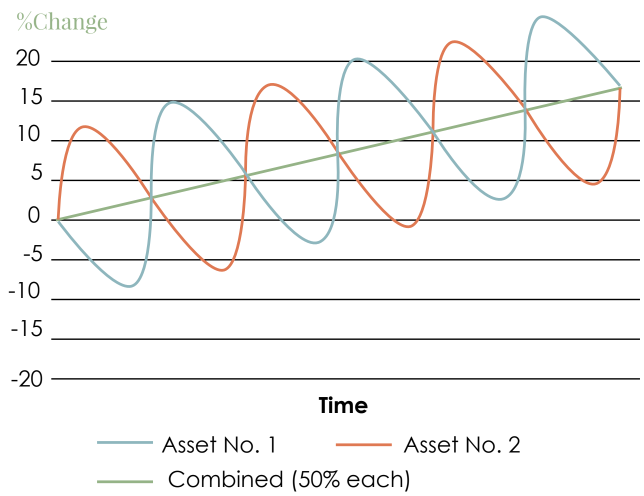
Source: Cowles Foundation paper 60

The green line shows the 'Efficient Frontier' – this is a series of points showing the level of risk you have to take to give you the greatest possible rate of return. At point A, and indeed anywhere in the shaded area, the portfolio is 'Inefficient', as the level of risk taken does not correspond to the maximum expected rate of return.

As an example, where asset allocation modelling is used to achieve a balance of asset classes, the portfolio can be moved to the Efficient Frontier. Here, it could aim to achieve either the same potential return for much less risk (B), or the same amount of risk could be taken for a greater potential return (C).

If you have a broad spread of shares or equity unit trusts, it could be argued that you have achieved balance and diversification. However, no matter how wide a range of equities you hold, they may be more or less susceptible to exactly the same market factors – they will go up together, and they will go down together. For effective balance you need to invest in assets with either 'low correlation' or 'negative correlation'.

In very basic terms, the graph below is an example of the value of investing in two negatively correlated assets. The assets are perfectly negatively correlated because as one is decreasing in value, the other is increasing in value by the same amount.



A combination of asset classes within your portfolio can therefore help reduce performance fluctuations, potentially providing steadier and more stable returns. Rebalancing over the years is essential if you are to remain on the efficient frontier, and should be undertaken during your annual review meetings, or more frequently depending on the investment solution you have in place.

How any portfolio is constructed will depend on the investment mandate, and we will consider the level of return required in the context of your willingness and ability to accept risk. We will seek to achieve an optimal blend to meet your specific requirements.

As noted previously, some risks can be controlled or mitigated, and your portfolio can be built, reviewed and adjusted to accept greater or lesser degrees of risk depending upon your requirements.

Different asset classes attract different degrees and types of risk, and can broadly be placed into six main categories:

Cash, Bonds, Equities (or Shares), Property, Commodities (e.g. gold) and Alternatives (assets which do not fall into one of the other, more conventional asset types).

The tower graphic below offers an indication of where individual asset classes may sit when considered in isolation, but when blended within a portfolio, the overall picture will generally look quite different.

Asset risk tower

Building an investment strategy

We will consider all relevant factors, including all, or a combination of the following:

- your specific objectives;
- the anticipated investment timeframe, when you anticipate needing to access the funds;
- your age;
- our views on current market conditions;
- our analysis of your existing investments;
- your overall risk profile.

We will agree an investment mandate with you, based not only on risk, but on any other requirements you may have, such as ethical or geographical preferences, then seek to meet your objectives by selecting an appropriate mix of assets. We will also consider other overarching requirements, such as generating income, growth, or a combination of the two, and the time frame in which to do so.

Diversification

We will seek to manage risks through diversification of assets. Diversifying your holdings across a variety of asset classes – which behave differently under different economic conditions – is a key method of influencing the overall risk of a portfolio and the potential return.

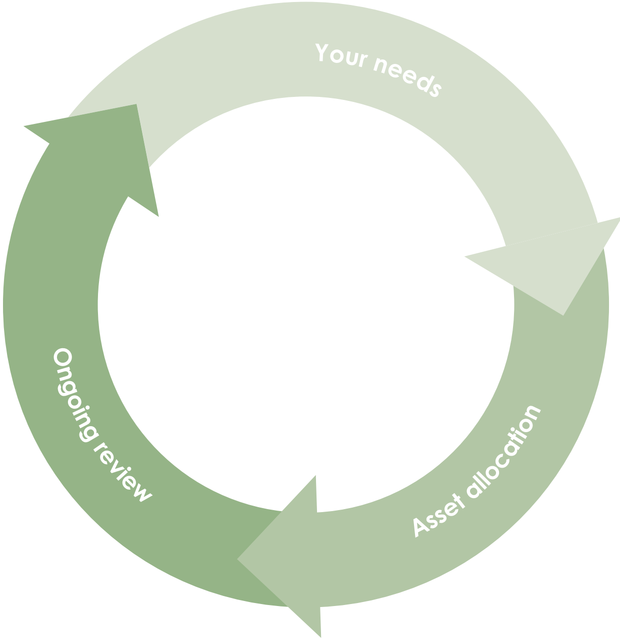
Diversification should, in theory, reduce the overall level of risk, compared with say a 100% equity portfolio.

Alternative assets can be useful in diversifying a portfolio, because they typically have a low correlation with standard asset classes in behavioural terms.

The investment cycle

Investment objectives

- Risk profile
- Time horizon
- Income requirements
- Responsible investing?
- Tax constrained?



Risk budgeting and asset allocation

Select the optimal mix of suitable assets:

- This will maximise the likelihood of meeting your specific investment objectives
- Asset and risk allocations
- Risk-adjusted returns

Portfolio construction

Select and recommend the most appropriate ways of accessing assets:

- Actively managed funds
- ETFs and index securities
- Structured investments
- Hedge funds

Portfolio management

Regularly review the suitability of your investments:

- Adapt to changing environment
- Monitor and rebalance investment risk allocations
- Report and communicate

Measuring investment risk & portfolio volatility

One of the measures we use to assess risk, is by comparing the volatility of the asset(s) in question, with that of a 100% holding in the UK stock market. This is often referred to as an 'FE score' and can be a useful benchmark.

By way of example, a cautious investor may adopt an FE score ranging from 40 to 60 as their benchmark, whereas a more speculative investor may adopt a benchmark FE score ranging from 80 to 120.

Fund selection

Our in-house Investment team works closely with Pacific Asset Management (PAM) who provide quantitative research and manage the TPO discretionary service.

The investment team and/or PAM meet with the fund managers who will be looking after our clients' investments. This forms a key part of our due diligence, which is conducted by the investment team to ensure we are comfortable with the funds, investment houses and managers that we recommend to clients. Our internal 'Investment Philosophy' documents our exacting standards for due diligence, which is a mix of quantitative and qualitative analysis.

A key consideration is the role we expect a fund to play within portfolios and the assets that it gives exposure to. It is important to understand that all holdings will be exposed to some degree of risk – even cash, which is exposed to the risk of inflation, and this is why a full discussion is so important.

A portfolio of investments is not just a collection of 'good ideas', it is a carefully constructed mix of assets that is designed to complement one another in different market conditions. Whilst past performance is a guide it cannot be relied upon, so we focus more on the reliability of the process used by a manager to generate returns. In analysing funds, we must have a keen understanding of the investment world we live in and so our team take time to understand the macro or top-down environment as well as the bottom-up analysis of individual funds or markets.

Your portfolio is at the heart of everything we do, and the Investment Committee sets the framework and monitors outcomes alongside the in-house investment team and PAM.

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