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How to build a portfolio

An investor's portfolio is simply shorthand for the collection of investments he owns. Ideally this will be spread across a variety of assets - equities, bonds, property and cash - in a mix which has been determined by his specific objectives.

The process of deciding how much to invest in each asset class is known as asset allocation. For example, equities have traditionally offered higher returns over the long-term but at the price of increased risk, while at the other end of the scale, cash has offered both security of capital and stability but with a fluctuating income and no chance of capital growth.

Actual returns are dependent on many variables, such as the health of the economy in which you are invested, inflation, interest rates and market sentiment. The elements that impact each asset class vary and one asset could provide you with good returns whilst another may be doing badly. However, it is difficult to predict which will do well - or badly - at any particular time, so mixing asset classes together and having exposure to a little bit of each can help balance out the individual peaks and troughs.

Your age, your financial position and your attitude to risk are all crucial considerations to get the proportions right and to build the most appropriate portfolio for you. It is therefore recommended that you speak to an expert to help you get the right mix.

Welcome to the latest edition of Grapevine, our update on developments in the world of financial services.

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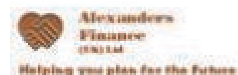
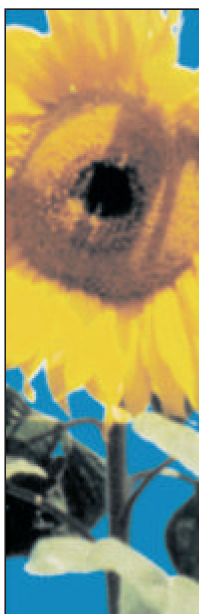




What is Deflation?

You might think that falling prices would be a good thing. However, a sustained and persistent period of deflation would have very negative consequences for the UK economy.

In a deflationary environment, consumers will delay making purchases, believing that prices will continue to fall. This makes it harder for companies to sell their goods, forcing firms to slash prices and leading to lower profits, declining wages and job losses. In turn, this leads to a reduction in disposable income and falling demand for goods and services, creating a sustained and damaging deflationary spiral.

Start Early

Because we're living longer - the Government Actuary's estimates put life expectancy at 91 for a female born today - it makes sense to maximise your pension, and the earlier you start saving, the more money you're likely to have. Indeed, the money saved into a pension between the ages of 25 and 35 can account for up to half your final amount. The main reason is the effect of compound interest, where the interest on money you save earns interest on itself over time. Start a pension at 25, say, and at 6% pa, £50 a month would provide £100,000 at retirement (age 65). Delay the start until the age of 35 and that same £50 per month produces just £50,000.

Avoid last minute suprises

Investing the money you save into a pension scheme requires careful thought and advice. The investment decisions you make can have a significant impact on the size of your pension in retirement, but it need not be as daunting as it sounds.

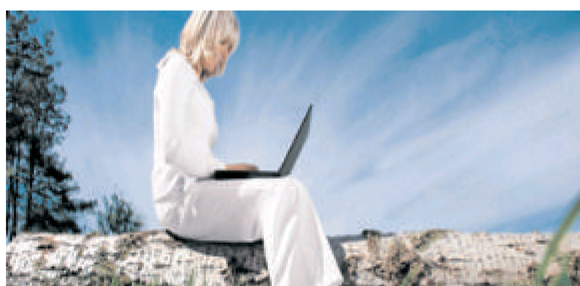
If you are in an defined benefit occupational scheme, the chances are all your investment decisions are made for you, but for those of us with money purchase and personal pension plans, the burden is on our shoulders. You therefore need to carefully consider the risk and reward involved to ensure it suits your objectives.

The range of options offered by pension providers is widening. Many not only offer a small number of their own funds but also now link up with external fund managers to offer third party funds as well. However, fundamentally, the decision is down to how you mix the four main asset classes – equities, property, bonds and/or cash – to maximise growth.

Equities have been the highest returning asset over the long-term, but are also the most risky, with the largest movements in price, particularly when measured over the short-term. Property can also fluctuate as demand is affected by the ability of companies to buy or rent premises. Bonds tend to be less volatile but are influenced by interest rates and therefore also move up and down. Cash is the safest asset class as your capital is secure – but it does not protect against inflation, there is no chance of any capital gain and income fluctuates with interest rates.

Long-term, therefore, it is common to put a greater proportion in equities, to maximise the growth potential, but to move slowly into more secure assets as retirement approaches. This ensures that any gains you make are 'locked' in, removing the risk that your pension will eaten up by any last minute downturn in markets.

It is important to carefully consider the trade-off between risk and reward. Putting all your money in one asset class will mean if that asset does badly the whole fund will suffer. Avoid chasing attractive looking performance as there is always a risk it will fall. By that same token, don't be too cautious, particularly if you are starting early, as this could mean miss out on investment growth and your pension ends up just a fraction of what it could have been.



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