

Schroders

A guide to investing



Schroders

Contents

1. Introduction

The importance of saving	6
--------------------------	---

2. Setting goals

Purpose of saving	10
Rainy day cash vs. longer-term savings	11
Getting involved in the stockmarket	11
Savings time horizon	12
Attitude to risk	12
The effects of inflation	13
It's all about time	13

3. Practical matters

Using a financial adviser	16
What are the costs?	16
Going it alone – using fund supermarkets	17
The cost of investing in a fund	18
Picking the right platform	19
Reduce tax on savings	20
Tax-efficient pension savings	20
Pension changes	21
Making the most of your options	22
Regular saving vs. investing a lump sum	22

4. Building a portfolio

The importance of diversification	24
Income vs. growth	25
A mix of income and growth	27
DIY portfolios vs. managed solutions	27
Understanding risk	29

5. Understanding funds

Passive funds	32
Active funds	33
Shares	34
Investment trusts	35

6. Investment focus

Bonds	38
Equities	39
Funds in fashion – choose themes carefully	40
Past performance vs. future potential	42
Don't forget to monitor investments	42

7. Jargon buster



About the author

Holly Thomas is an award-winning financial journalist and former Deputy Personal Finance Editor at The Sunday Times. Holly writes across all areas of personal finance and consumer issues, specialising in investments, pensions and property. She has previously worked at the Daily Express and Sunday Express and Financial Times Business. Holly was voted Freelance Journalist of the Year at the Association of British Insurers Media Awards, and won the title of Best Consumer Advice by the British Insurance Brokers Association. Her work can be seen in national press, including The Times and the Mail on Sunday.

1



Introduction

5

The importance of saving

6

1. Introduction



The importance of saving

Adopting a regular savings habit is crucial because while the circumstances of British savers varies widely according to demographics and region, the picture is clear – far too many people have inadequate savings.

The good news is that people are becoming increasingly aware of the growing importance of having a robust fund for a safe and secure financial future. Simply put, saving today will provide you with flexible financial resources in the future.

Before introducing any risk to your money by investing in the stockmarket, you need some core savings as an emergency fund for those unforeseen events. Most people start by putting some money away each month into a cash savings account with a bank or building society. It is only when this emergency pot has been built up, and disposable income increases, that it's right to start thinking about how to make savings work harder.

Investing money in the stockmarket offers opportunity for improved returns that are likely to exceed any interest rate a high street bank can offer. While it's true that the value of your stockmarket savings will fluctuate, introducing risk becomes less of an issue if you are investing over the longer term. Historically speaking, stockmarket gains far outweigh cash.



Saving and investing isn't right for everyone all the time, because many households have unsecured debts. Any disposable income might be better off put towards clearing those debts before addressing a long-term investment strategy.

Interest rates on borrowing are likely to be far higher than any returns, so it may be sensible to stick to current repayment plans. Whether or not you should invest will depend on your individual circumstances.

Timing aside, saving for the unexpected and equally, being prepared for the expected – retirement – is essential. Recent decades have seen life expectancy across the UK rise at a surprisingly fast rate and the responsibility increasingly lies with individuals who cannot rely on the State to provide them with the kind of lifestyle they would like.

Not everyone can afford to save as much as they would like each and every year, but putting a little something away every month is better than doing nothing. Over time even small contributions could build up to a sizeable fund.



The ultimate secret to financial success lies in having your money doing the work so that you have peace of mind that your cash is working hard.

2

Setting goals	9
Purpose of saving	10
Rainy day cash vs. longer-term savings	11
Getting involved in the stockmarkets	11
Savings time horizon	12
Attitude to risk	12
The effects of inflation	13
It's all about time	13

2. Setting goals



Purpose of saving

Setting goals is important because it will help with deciding what kind of investments are suitable. What drives each of us to save can differ enormously. Yet most savers have a goal, which can be anything from your own future to supporting that of others.



A larger family home or having enough capital stockpiled to pay off an existing mortgage is often top of a wish list. Saving in advance to raise a family is wise, as is planning for retirement which requires a substantial monthly commitment if a comfortable standard of living is to be achieved.



Helping younger family members financially is becoming more common with expensive university tuition fees to pay and soaring house prices increasing the amount needed as a deposit. University costs can push young people into debt before they even reach the workforce which makes saving for a deposit even more of a struggle. It's not just grandchildren who need financial support these days. Offering help to grown up children is also becoming more widespread as the cost of living increases, salaries often remain frozen and house prices continue upwards.

Whatever the motivation behind a savings plan, there is an appropriate path to reach that goal. Some types of investments target a certain amount of return (which of course cannot be guaranteed), while others suit a longer term plan, such as retirement, where the prospects for healthy returns are much further into the future. Other types will suit those who need their money to generate an income, either to bolster their earnings or to live off when they quit work altogether.

Regular saving is important to ensure that you can have the lifestyle of your choice – and not just what a bank balance dictates.

Rainy day cash vs. longer-term savings

Before feeling comfortable investing in stocks and shares it is wise to have a fund that you can call upon in case your income drops – or even disappears – and you need to pay the mortgage and household bills. It is also there for when the boiler packs up or you suddenly need four new tyres on both family cars. This same pot might include money for treating the family to a luxury holiday or perhaps a brand new kitchen.

There is no hard and fast rule on how much money should be squirrelled away in a savings account as an emergency or rainy day fund. But a rule of thumb suggests it should at least be enough to cover essential outgoings for around six months. It is then wise to have savings that you don't need to call on for at least three to five years – and some further into the future. These can be earmarked for much longer term plans such as property purchase and money to live on in retirement.

Getting involved in the stockmarket

Whether you're cautious or adventurous, investing offers the chance to beat interest from the high street banks and potentially generate more growth and income. There are a number of ways to get involved in stockmarket investing and the right one for you depends on your attitude to risk and how much money you have to save.

Buying individual shares gives you the opportunity to benefit from the success of listed firms in a range of markets, for example the London Stock Exchange. Alternatively, investment funds from asset management companies – also known as “mutual funds” – offer the opportunity to invest in lots of different stocks through a single investment. Your money is pooled with that of other savers and invested by a fund manager.

This manager can select firms that are already successful or perhaps those expected to flourish in the future. These can be UK companies or companies in other countries or regions, in many different industries and sectors.

Savings time horizon

Timing is everything, as they say. The length of an investment is just as important to recognise as the purpose, and is particularly relevant when deciding on a home for your nest egg. Placing your cash in the stockmarket isn't ideal if you suddenly need to access it.

While you can draw on money invested in the stockmarket at any point, it might be a bad time to do so, if for example, the market has taken a hit. Share prices can be volatile over shorter time periods so if you're saving for a mortgage deposit over a year or two, then it is not a good idea to have savings that might be plummeting in value when you need to cash in. Selling out when the market is low means turning a theoretical loss into a real one.

This is why a rainy day fund is often best kept in a deposit account where it can be accessed any time, without timing issues – or penalty. Remember, even with a simple savings account it is important to make sure the money is working hard in an account paying the best possible rate and in the most tax efficient manner which means looking at ISAs – or NISAs as they are now known (see page 20).

Over longer periods investing in the stockmarket typically proves successful in terms of returns, so for long-term savings this is the place. Most experts say you shouldn't invest in shares for any period shorter than three years – some say it should be no less than five years. This is because it's not possible to read the market (without the aid of a crystal ball) and in any shorter period there is less time to win back any losses. Markets move in cycles – but slowly.

Once you are in a position to invest, it is important to address the element of risk that will be introduced.

Attitude to risk

To earn a better rate of return than you would typically get from a savings account you need to accept more risk. That means getting comfortable with the fact that your investments will go down in value some of the time. While the long-term direction of the stockmarket is up, it doesn't rise in a straight line.

The rule of thumb is that the more risk you take, the greater the potential return – but also the greater the potential loss. Are you happy to sit out volatile markets in the short term, or will you lose sleep if the markets fall? Stockmarket investments can be a bit of a roller coaster which is fine, unless that is out of line with your expectations. Ideally you should think about what you can afford to lose. Before investing, think about how you would cope if your investments fell by 10%, 30% or 50%, then you can set a limit for yourself.

The effects of inflation

In reality, even cash is not without risk. In choosing the supposedly safer option of cash as a long-term investment, it is almost certain your money will fall in value over time as it is slowly but surely eroded by inflation.

The effect of inflation is commonly underestimated and savers who have remained loyal to cash deposit accounts have suffered the damaging effects of rock bottom interest rates. Since they have remained at 0.5% since March 2009, the buying power of nest-eggs has been slashed, while those who opted for stockmarket investments would have seen better returns. It is crucial to make sure your money is growing at a pace that beats inflation.



**£1 of goods and services in 2004
would cost £1.38 today**

*Source: ONS, as at 30 September 2014

It's all about time

Usually, the longer your time frame, the more aggressive you can be with your investments – although this depends on your individual appetite for risk. So those saving for a pension might consider higher risk investments, knowing the money will not be needed for many years and that there is plenty of time to ride out any short-term losses and see the value of the investment recover.

Your attitude to risk is likely to change with time, and you may become more cautious the closer you get to retirement. When you start a family you might suddenly want to scale down risk to protect money you have put aside to support your new offspring. There are different risks with the varying ways in which to invest. Backing companies as a shareholder can reap rewards but can be deemed risky because if a company hits rocks, your savings will plummet.

Investing in funds is one way of spreading the risk because the fund manager chooses a range of companies which are invested in on your behalf. If one company falters, it's not as disastrous if the others are doing fine.

3.

Practical matters	15
Using a financial adviser	16
What are the costs?	16
Going it alone – using fund supermarkets	17
The cost of investing	18
Picking the right platform	19
Reduce tax on savings	20
Tax-efficient pension savings	20
Pension changes	21
Making the most of your options	22
Regular saving vs. investing a lump sum	22

3. Practical matters



Using a financial adviser

A financial adviser can help with investing or saving money, planning for your retirement, making the most of a lump sum of money such as a redundancy payment or an inheritance as well as tax issues. They can match you with the right kind of investment by ascertaining your circumstances, goals and how you feel about taking risks with your money. They can also manage your investments once they are in place, and help re-order things when your life changes.

What are the costs?

You do have to pay for advice which adds to the cost of investing. But of course, it's money well spent if the adviser can help you choose a product that is better suited to your needs and may perform better than one you might choose yourself.

Advisers require a payment like any other professional. Prior to November 2013, financial advisers would receive a commission payment from the investment provider. Now, they charge a fee directly to you for providing advice.

There are two different types of advisers. Some are 'independent' – meaning they offer advice on the full range of investment products from the market, while others offer a 'restricted' service meaning that the range of products or providers they will make recommendations from is limited. It is important to be clear about what they can offer you.

An element of consumer protection is built in to taking professional financial advice. If you buy an investment which loses money and the risks were not properly explained to you then you could claim compensation through the Financial Ombudsman Service. This is not a scheme designed to compensate if the investment doesn't perform – only if it's mis-sold. It is crucial to understand what you are buying as well as the risks involved before you sign on the dotted line.

To find the right independent financial adviser one option is to get a recommendation from a trusted friend. Alternatively, go to [unbiased.co.uk](https://www.unbiased.co.uk), which recommends local independent advisers, or call on 0800 085 3250. Here you will also find a full list of the different qualifications an adviser can have as well as the professional bodies that represent them. You can also look on [vouchedfor.co.uk](https://www.vouchedfor.co.uk), which allows consumers to rate and review advisers they have used. Financial advisers have to be authorised by the Financial Conduct Authority (FCA).

However, more and more people are choosing to handle their own investments to cut adviser fees and because they want to take control of their finances.

Going it alone – using fund supermarkets

Using a fund supermarket you can put in place a series of investments without the help, or cost, of an adviser. Fund supermarkets, also known as platforms or discount fund brokers, allow you to buy, sell and manage shares and funds from companies and many different providers. As long as you are confident enough to make your own investment decisions they offer a straightforward way of investing from the comfort of your own home.

They allow you to place your chosen funds and shares within tax efficient savings schemes such as a NISA and a Self Invested Personal Pension (SIPP), as well as arrange standard investments made outside these tax shelters.

Online tools

To bridge the gap of financial advice and cater for the increasing number of so-called “DIY investors,” firms are offering lots of guidance on choosing funds. An array of sophisticated low-cost as well as free online tools are available to help you choose and manage funds. These include access to performance figures, commentary and opinion as well as fund ratings. They are increasingly introducing ways of helping users work out what investment they might want to consider, which for an ordinary investor will be a welcome helping hand since there are more than 2,300 funds to choose from.

Since risk is such an important element of choosing investments there are online tools that platforms offer which will help you identify funds that are matched to your own risk profile. There are some that provide an online questionnaire to decipher your attitude to risk and investment goals which will generate a list of suggested funds or even ready-made portfolios.

Many also offer lists of recommended funds which aren't tailored to individuals but are a result of in-house research. These lists can provide a useful guide, source of inspiration and validation of your existing fund choices but are not to be confused with advice – it is just guidance which means it is not tailored for individual circumstances.

It is possible to go straight to the asset management company which runs the fund you have chosen to invest in one of their funds, however fees are generally lower via a fund supermarket. It also means you hold all your investments in one place which is far easier than keeping up with a long list of firms.

The cost of investing in a fund

When you invest, there are a number of parties involved in helping manage your money, and they charge for their services accordingly. Here are some of the costs you can expect to incur when you invest.

An **investment platform** will charge an amount for their service; usually a portion of the amount you invest.

e.g. 0.25% a year to the value of your fund

Your adviser will charge an amount for their advice; usually a fixed lump sum, or an hourly rate.

e.g. £150 an hour

A **fund manager** may charge one-off charges, such as: An *initial charge* when you enter the fund; or an *exit charge* when you exit.

They also set annual charges: The *Ongoing Charge Figure* (OCF) to pay for administration, operating costs, investment management and independent oversight; some funds also charge a *performance fee* to reward the manager for superior returns or for outperforming their specified targets.

Remember, investing is not just about price. While keeping a lid on costs is important since charges will eat into returns, the emphasis should be on value for money rather than the price in isolation. Paying more for a fund with excellent returns is better than a cheap fund that offers poor returns.

Picking the right platform

There are lots of fund supermarkets to choose from. You should select one according to how easy the site is to use, how much it costs and the quality of customer service as well as the range of investment choice available.

Picking a platform which offers good value for money gives you the power to boost your investments. Paying less in charges means returns will not be eroded by hefty fees and commission. Costs between different fund supermarkets differ vastly so that one investor could pay thousands of pounds more than another for running exactly the same portfolio with a different firm.

The cost of your investment will depend on how you run your money over the year. Will you be trading or switching? Charges for buying and selling funds, branching into other investment types and even exit fees if you move your holdings to another platform, can soon add up.

Some of the more expensive services reflect the added research facilities and focus on top quality customer service while the no-frills brands are cheaper, but offer less of the extras. Exit fees can be steep, so it's worth doing some research before you get yourself set up. You can compare costs at [comparefundplatforms.com](https://www.comparefundplatforms.com)

There are other ways to maximise returns using the various tax breaks given on NISAs and pensions.

Reduce tax on savings

There are a number of ways you can keep costs down by using tax-efficient savings available to you.

ISAs vs. NISAs

To encourage UK savers, the government allows individuals to invest a certain amount each tax year without having to pay tax on their gains.

These savings, formerly known as ISAs (Individual Savings Accounts), were renamed as New ISAs or NISAs from 1 July 2014. Savers can shelter a mixture of cash and stocks and shares up to £15,000 each tax year in their new-look NISA, which does not need to be declared on any tax return. This means regular savers can put away up to £1,250 a month.

Parents can also save in a Junior ISA for under 18s. The rules allow you to save £4,000 in the current tax year.

ISAs and now NISAs are very attractive because all income and gains are tax free.

Tax-efficient pension savings

Pensions offer another tax-efficient way of saving. You get a tax top-up when you pay money in, at the rate of 20%, 40% for a higher-rate taxpayer or 45% for top rate taxpayers.

So, every £800 you pay in will automatically turn into £1,000, which you could see as an instant return. Higher-rate taxpayers can claim back an additional £200 through a self-assessment form boosting their return even higher. There are however tax implications when it comes time to draw on your pension.

Self-invested personal pensions (SIPPs) are an increasingly popular form of personal pension that give investors the freedom to choose and manage their own investments.

SIPPs are DIY pension funds that can be built and managed online via a fund supermarket. Around 1 million savers are using this type of pension today*.

They were previously the preserve of the most sophisticated investors, but now they are viable for more modest savers thanks to the cost of running them becoming more affordable over the years. They offer the flexibility of holding a wide range of assets – from stocks to property – in a tax shelter while gaining tax relief on the contributions.

*Source: Financial Times, as at December 2012

Savers can contribute up to 100% of their annual income to a pension before tax, up to £40,000, each year. There is also a lifetime limit for pension contributions of £1.25 million.



The tax benefits of SIPP's are clear, and you do not have to retire from work to take benefits, under current government legislation, you can begin drawing cash from the fund at any age from 55.

Pension changes

From April 2015, anyone who is aged 55 or over will be able to access every penny of their pension savings, with the first 25% tax free. The remaining 75% of the fund will be taxed at the saver's marginal rate, rather than the current 55% charge for full withdrawal.

Once the cash has been removed investors may need to find a new home for this money to generate an income. While many will choose an annuity – an insurance policy that pays an income for life – others will want to retain control over their original fund and use it to generate a regular income.

Making the most of your options

There is no need to choose between NISAs and SIPPs, as the rules allow you to have both. A mixture of saving through SIPPs and NISAs will be appealing to the majority of investors who want to utilise the tax breaks.

The process of choosing funds is the same but there will be income tax to pay on dividends and capital gains tax to pay if investments are sold with a gain.

Regular saving vs. investing a lump sum

Timing the market is one of the hardest parts of a professional fund manager's job, so for private investors to attempt this is an even taller order.

The time an investment is made – that is, when you “buy” into the market, can have a big impact. If you choose to invest right before a certain area takes a hit, you could see the value of your savings drop overnight. It all depends on the share price of all the different stocks you are investing in.

A much favoured trick by experts is drip-feeding your money into the market, which removes the need to get the timing right. By saving a monthly amount into your investment portfolio you can cash in regardless of how the market is performing. It smooths out the highs and lows in share prices. When they go up, the value of your stocks rise, and when they go down your next contribution buys more. This is known as “pound-cost averaging”. Plus, buying stocks at a lower price means you get a higher return when the market swings back up.

This is a prudent approach even for those with a lump sum to invest, from a bonus or inheritance perhaps, who could divide the sum into 12 equal amounts and drip-feed the money in monthly.

Either way, with even a seemingly small contribution each month, the cash can soon mount up and over the long-term can grow to a decent sized fund.

4

Building a portfolio	23
■ The importance of diversification	24
Income vs. growth funds	25
A mix of income and growth	27
DIY portfolios vs. managed solutions	27
Understanding risk	29

4. Building a portfolio



The importance of diversification

The idea of diversification is that if one investment has a bad time you will always have others that will ideally not be suffering, so they act as a counter-balance.

The “asset allocation” or in other words, how you divide your money between shares, cash, fixed interest securities or property is crucial. A common mistake investors make is not diversifying enough: as a result, some have been burnt by having all their eggs in one basket – in other words, all their money in one asset class.

Diversification is indeed the key to managing of risk – including volatility. Of course there is market risk which cannot be avoided. That is, for example, if the whole global economy and markets crash then more or less every asset class will suffer. A financial adviser can help you determine the level of risk you’re comfortable taking on.

To make sure a portfolio is spread across asset classes, it could contain a blend of equities, bonds, cash, property and others, such as commodities and gold, to benefit from their different investment cycles.

It is easy to think you are well diversified if you have a selection of UK equity income funds from different fund managers, for example. These are a core element and popular choice of many NISA investors' portfolios and with good reason. Some of the most popular funds have served investors extremely well. Those who have benefited from impressive returns might be tempted to fill their investment portfolios with other income funds. But many contain the same stocks, such as Vodafone, GlaxoSmithKline and Royal Dutch Shell, which means you are not as diversified as you might think. It is far better to have a wider spread of holdings and therefore a wider spread of risk by buying several different types of funds with exposure to different asset classes, sectors and also different countries.

As well as funds which invest in companies listed in the UK, there are global funds to choose from that invest in companies listed on overseas markets. Investing further afield provides more opportunity for diversification and gains access to countries where economic growth and profit growth can be higher than in Britain.

At the other end of the scale, it is also a mistake to over-diversify. Some investors hold so many different asset classes or funds that the impact of any individual part of their portfolio is diminished and they just end up with an expensive tracker style fund (see "passive funds" on page 32).

Income vs. growth funds

Income funds

An income fund typically aims to deliver a steady or growing stream of income, which can be paid out directly to an investor, or alternatively it can be reinvested in the fund.

An income fund manager is concerned about the level of dividend that a company pays, and how likely it is that the dividend will be paid consistently into the future. Getting an income from an investment is often an important requirement for people who are retired or approaching retirement or even those still working who need to supplement their salary.

Due to the regular dividend payouts these funds also have long-term appeal, because if the dividends are reinvested they can boost returns over time. In fact, reinvested dividends provide the lion's share of total returns in the long run, thanks to compound interest. This simply refers to the fact you earn interest on interest or more specifically in investment terms, generating income from previous income. The effect is so powerful that you can save less for longer and still be better off than saving a lot in a short time.

Income funds have proved very popular during the prolonged period of ultra-low interest rates. Crucially, they offer the prospect of inflation-beating returns to protect the buying power of your savings, which can be hard to find.

Income can also be taken from bonds, also known as fixed income investments, which are popular with those who like to have peace of mind there will be regular payments for a fixed period.

Growth funds

A growth fund aims for capital appreciation – that is, for your money to grow – over time. Fund managers in charge of your money can steer a fund either way by focusing on different kinds of companies to invest in.

Growth funds are popular among long-term savers who do not need to take an income from their investments. Growth fund managers will typically choose to invest in companies that they believe will be able to significantly grow their earnings over time. They focus on firms that reinvest their dividends in their business rather than paying out profits to shareholders.

Some managers prefer to invest in smaller and medium-sized companies, believing there is more opportunity for growth. While they can be more volatile in the short-term than income producing funds, they can provide investors with far greater returns over the long-term. Others prefer to take a more defensive strategy, investing in top-quality blue chip companies – the likes of BP or Vodafone – that are potentially less vulnerable to going bust.

A mix of income and growth

Some funds provide a mixture of income and capital growth. A portfolio with a mixture of the two is a good idea because ultimately most savers are looking for investments that generate an income, protect their capital and provide potential for capital growth. As your financial situation changes over time, you should be prepared to make the necessary adjustments to your portfolio, and switch your balance of growth funds and income funds as your investment needs change. By holding a variety of investments, both growth and income, you should be better prepared for whatever economic ups and downs might lie ahead.

DIY portfolios vs. managed solutions

Confident and experienced investors may be happy researching and choosing their own funds. Others will want someone to do it for them.

A survey by research group the Platforum revealed a third of those that run their own investments said they “enjoy looking after their investments and are happy to spend time going into a lot of detail to get it right*”.

*Source: ‘Stickman: The Consumer’s Investment Journey,’ The Platforum, 2013

However, not everyone is quite so excited by the idea of poring over fund factsheets (which tell you everything you need to know about a fund including what it invests in), performance figures and share prices. Equally, many people cannot spare the time to construct their own portfolios and monitor them over the long term.

An ‘off the shelf’ portfolio

For these people, there are ready-made portfolios that can be bought with far less hassle. Savers can select a package of funds carefully selected to suit various types of investors according to their financial objectives and attitude to risk. This so-called “managed solution” is a portfolio assembled and managed by an expert.

These are not tailored to an individual saver in the same way a bespoke portfolio compiled by a financial adviser would be. Although some advisers use them too.

Investors can buy multi-manager or multi-asset funds, which bundle together a group of funds under one umbrella.

The idea is that they can offer investors a decent one-stop shop opportunity. These funds can invest not only across a wide range of assets including equities, bonds, commercial property, cash and sometimes commodities, but also cover a large spread of different countries. By mixing a variety of managers across various investment markets, in a single fund, multi-managers aim to produce consistent performance. Like a managed solution, all an investor has to do is pick a portfolio with a risk profile that suits them and the manager will take care of the rest.

There are, of course, extra charges for these off-the-shelf portfolios.

Risk-managed solutions

There is also the option of funds that are based on your appetite for risk. They fall into two categories:

1. **Risk-rated funds** are based on the past performance of the fund as well as other historical data on how the fund performs in certain market conditions that can help match the investor's appetite for risk to the fund.
2. Although the names are similar, **risk-targeted funds** are completely different. They use models and assumptions to forecast the possible variations of returns over a time period of at least five years. As such these funds are goal driven investments, which mean they can be closely aligned with an individual investor's savings plan.



The idea behind these funds is to make the selection process simpler – all you have to do is choose the fund that most closely matches your attitude to risk.

However, it is worth bearing in mind that the performance of these funds can be markedly different from what investors expect. There are no guarantees, only targets.

The focus on risk by the Financial Conduct Authority has prompted the emergence of funds specifically designed to address this issue with “risk targeted funds”. This is entirely different from risk ratings. Risk targeted funds target a level of risk rather than a return.



Understanding risk

Risk is an important part of investing – and a complicated issue. There are many measures and definitions.

Volatility – the up and down movement of the market – is one measure. Investors only worry about volatility when shares are falling. When this happens, remember that any loss or gain is only realised when you sell your holdings. Investments are for the long term, so short-term volatility is not necessarily a reason to panic and make drastic changes.

Other measures are personal to each saver. They can be losing some of your money, being unable to meet your expenditure, not having enough income and seeing the spending power of your savings eroded.

Most funds regulated in the UK are given a numeric risk & reward-rating based on past performance. Although please bear in mind that past performance is not a reliable guide to future performance and may not be repeated. It's also worth noting that a risk rating The “risk & reward rating” is provided using a numerical scale from 1 to 7, as ordered by the Financial Conduct Authority, that is published in a document offered alongside each fund – called a Key Investor Information Document or “KIID”.

Independent firms assign funds a separate rating based on volatility, asset allocation (how the investment is split across asset classes), as well as how each manager runs the fund. Most use a scale of 1-10, where a very low risk cash fund is 1 and a very volatile fund is rated 10.

Different funds will have different risk profiles. For example, an emerging market equity fund will be deemed to be higher risk than a UK equity fund, as emerging market economies are considered less well-regulated than those in the UK.

Even within each sector, different funds will have different risk profiles too – one emerging market equity fund may be more risky than another.

Risk-ratings are based on the past performance of the fund as well as other historical data on how the fund performs in certain market conditions that can help match the investor to the fund. Some funds are deliberately packaged by asset management groups to attract those who want to invest based on their attitude to risk.

It's worth noting that risk profiles can change with time and a rating might not reliably indicate the future risk profile of a fund.

5

Understanding funds	31
■ Passive funds	32
Active funds	33
Shares	34
Investment trusts	35

5. Understanding funds



Passive funds

The choice between active and passive is often debated and there are pros and cons to each. The right choice for you will depend on your individual goals and circumstances. Here we go through the two approaches.

With passive funds, the fund manager does not attempt to beat the market as in active fund management. Instead, they try to mirror the performance of a selected market index, like the FTSE 100.

These are known as “tracker” funds and are typically cheaper to run than active funds because there is no research, or fund manager expertise to pay for – the investment process is automated.

Tracker funds are popular because of lower annual charges which is good because charges will erode returns. But while they aim to mimic the returns of a market or index rather than actively pick winners, they can miss out on opportunities in some markets that have a particularly good run.

Tracker funds are all different. Some will buy shares in all the companies that make up a particular index, while others will track an index by buying a cross-section of companies. This is why the performance of, say, a FTSE All-Share tracker may differ between providers. You need to know in what you are investing, what you are paying, and how the fund would be expected to perform in different circumstances.

Exchange-traded funds

Another “passive” option is exchange-traded funds (ETFs), which are floated on a stock exchange and traded in the same way as shares. Buyers purchase shares in the fund which trades on an exchange. Like index tracking funds, they aim to replicate the performance of a chosen index – for example, the Standard & Poor’s 500 in the United States or the FTSE All-Share in the UK.

Many ETFs invest directly in the components of an index, such as gold. They are bought through a stockbroker, so there are dealing charges to pay – this is a particularly important point if you are making regular savings, as these dealing charges will be incurred every time an investment is made. The costs can build up, especially if the amount being saved each month is relatively small.

Active funds

Fund managers and their research teams spend their time selecting companies they wish to invest in, deciding on buying and selling at the right time. They are responsible for making sure that each and every stock a fund invests in is a viable business with decent prospects for either income or growth.

It is important for them to understand the nuts and bolts of a company and not just what the accounts show.

This is why researchers and analysts will visit companies and often quiz everyone from the finance manager, of say, a retailer, to those who work on the shop floor about how the firm is run.

It is the skill sets of people that can make all the difference as they strive to achieve above average returns. Fund managers monitor the markets and make judgments based on what’s happening. Quality managers have proved solid performance is not just good fortune by running successful funds under different companies.

One way to illustrate their performance is to compare the number of months when a manager beat the market as opposed to underperformed. This way you will see an indication of consistency and a manager’s worst losing streak.

The skill and thorough research is the reason behind why active funds are typically more expensive to run than their passive counterparts.

Of course, not all managers get it right every time and sometimes funds that have had a good run will suffer from the effects of certain market conditions. To beat the stockmarket fund managers have to do something different to buying the market. As such a good active manager is likely to underperform at some point.

Shares

Being a shareholder is a popular pastime and if you are lucky you could make a substantial gain – but you could equally make large losses. This route is riskier than buying a fund which spreads the risk by investing in lots of different companies. Any company, no matter how profitable or well established can be hit by unforeseen events. The price of shares can go up or down if sentiment about a company changes.

Buying shares

To buy or sell shares, there are dozens of online “execution only” brokers with relatively low charges. Commission is charged on trades which covers the cost of carrying out the deal.

Earning an income

Some, though not all, shares offer income in the form of dividends. The size of the dividend paid by a company can be affected by a number of factors, including company size or the earnings of the company in any given year.

Diversifying your shares

Holding shares in one company is very high risk. Buying shares in a variety of companies along with other assets and using pooled investments is a more balanced approach.

Shares from big UK companies are traded on the London Stock Exchange are known as listed shares. Smaller, more risky, companies are traded on the Alternative Investments Market (AIM). You can also access companies on exchanges around the world, such as the New York Stock Exchange.

Investment trusts

Investment trusts are companies that hold assets such as shares. Investment trusts are run by a fund manager, but are backed by an independent board which is appointed to act in the best interests of shareholders.

One key feature of investment trusts is the pricing. Unlike unit trusts, the trust itself has a fixed number of shares and as such they are also known as closed-ended funds. Since it has a limited number of shares, values go up and down according to demand and market activity as well as on the basis of underlying investment values. This difference between the trusts' share prices and their real worth can sometimes enable investors to buy assets cheaply, although this can also work against an investor when they come to sell their investment.

When the price is greater than the value of the assets held in the company, this is known as a premium. At a time it is less, it is known as a discount.

Most investment trusts are also allowed to borrow, known as “gearing”, which is another special feature of these investments. If managers think there is value in a particular market, they can borrow money to use for further investments. This can magnify gains in a rising market. But the more borrowing a trust has, the greater the risk to your money.

6

Investment focus	37
■ Bonds	38
■ Equities	39
■ Funds in fashion – choose themes carefully	40
■ Past performance vs. future potential	42
■ Don't forget to monitor investments	42

6. Investment focus

Bonds

Bonds – also known as fixed income securities – work differently to equities or shares. They are in effect, IOUs or loans from governments and companies, and while the value of equities can fluctuate, the returns they receive from bonds are already fixed.

They tend to attract those more cautious investors who don't like the idea of the value of their money fluctuating. Some investors, particularly those reaching retirement, may want some sort of allocation to bonds for the sake of portfolio diversification, income and as a lower risk complement to equities.

Bonds issued by governments

Investors have a choice of bond funds which invest in several fixed income securities and generally focus on a particular sector, such as corporate or UK Government bonds, or “gilts.”

Gilts are widely regarded among the safer bond investments since they are backed by the UK government and therefore have the highest credit rating, but as such returns are lower than others.

Bonds issued by governments in emerging markets are often given a lower rating as they can face political uncertainty that may affect their ability to pay back the debt. Investors are generally compensated with a higher potential return for taking on this additional risk.



Bonds issued by companies

Corporate bonds are issued by companies and within this sector there are different types. Those with strong balance sheets are known as investment-grade bonds. Companies with a higher level of risk associated with them are known as high yield.

The impact of interest rates

The value of bonds is sensitive to changes in interest rates. Bond yields move in the opposite direction to prices. With interest rates potentially rising, investors will be aware that the prices and yields will be affected – in particular, government bonds and investment – grade corporate bonds. High-yield bonds are usually less affected because they have less sensitivity to interest rates.

How to buy and sell bonds

Bonds are not traded on a stock exchange which means you need a buyer if you wish to sell. If you want to access your money and there are extreme market conditions, it may be harder to do so.

It is also worth knowing that bonds are issued in different currencies and so there are currency risks should you own one that is, say in US dollars.

Equities

As returns on savings and yields on bonds – historically the next step up on the risk scale from cash – have slumped, savers have been turning to equities.

Equity holders take a stake in a company by owning shares which are issued by companies as a means of raising money. Essentially, companies are selling part of their business to investors, and these shares offer people outside the company the opportunity to receive profits if the company is successful. When profits rise the share price typically goes up meaning a shareholders investment increases in value. The return from equities varies the most from year to year, but tends to be highest of all over long periods.

Funds in fashion – choose themes carefully

Within the investment world there are many different sectors and industries in which you can invest. It can be a good – and exciting – way of cashing in on particular sectors that do well. Here, we go through some examples.

Emerging markets

One of the most commonly debated themes is the emerging markets. In investment terms, these are countries whose financial markets are less developed and where investor protection and market infrastructure is often weaker than in developed markets such as the UK.

For example, Eastern Europe includes the likes of Turkey and Russia, and further afield, Asian countries such as China and India.

Some have been top performers and many people strongly believe emerging markets have strong economic growth potential thanks to a young and growing population, durable consumer spending and a prospering middle class.

It is hoped that this growing demand for goods and services in the emerging markets will be sustained as incomes continue to rise and seeks to take advantage of economic progress taking place in the developing world. Some funds target global consumer brands, rather than investing directly in emerging market companies, to benefit as consumption rises rapidly across the East.

There are funds that cover a spread of countries, and also country-specific funds although these are probably for brave investors only. Economies in these countries are often unstable which increases their risk rating. When a crisis hits a country, it can seriously affect funds that invest heavily in that particular region. Unless you have nerves of steel, investing in more general emerging markets funds where a fund manager can run a diversified portfolio and dictate which markets to invest in could be less risky.

Small companies

Small companies are another area of interest. While a large established company can offer steady returns and protection from sharp falls in most cases, smaller companies have more headroom for the kind of rapid growth that can see share prices multiply. Since they are less well known there are more hidden gems. However, being small firms, they are more vulnerable.

AIM shares – smaller companies not quite ready for the main stock exchange – have been a good hunting ground for companies rising through the ranks.

Property

Property is a constant source of discussion and is often a hot topic. Growth in the residential property market has been accelerating with more people interested in snapping up a buy-to-let property or even downgrading their own home.

Commercial property has been attracting attention too. Commercial property has only relatively recently become easy for small investors to buy into following the last property crash. Some funds combine investors' savings and buy office blocks, shops and other properties which they let and manage. Others own the shares of property companies.



Whatever your area of interest, focusing on the latest trend or purchasing last year's winners is almost always a big mistake.

It can be a quick way for novice investors to lose lots of money, as many found to their cost when the technology bubble burst back in 2000. Too many invest at the top of the market after strong performance has already been achieved – and miss the boat. Many then sell out when losses have already been made. Experts are unanimous that investors should ignore fashions and instead build a well-balanced portfolio with a string of themes selected.

Past performance vs. future potential

While experts have drummed into investors that past performance is no guide to the future, it's something every saver will check before handing over their hard-earned cash. You will see warnings by firms to say "past performance does not guarantee future returns" or something similar.

It is true, because investment returns tend to go in cycles. One style or market segment does really well for a period of time and then lags behind. Value and growth investing styles come in and out of fashion and industries can suffer from unexpected shocks, such as the technology bubble bursting.

However, that's not to say performance is not a consideration. It comprises one of several for choosing an investment. Rather than looking at performance figures for the last year, make sure you go back over the medium and longer term to ensure decent performance is not a one off.

Don't forget to monitor investments

Once you have constructed your portfolio you will need to monitor it to make sure it is performing as you had hoped and that you are on track to achieve your goal. A financial adviser will review your investments in, say, an annual meeting. But those that have taken the DIY route will need to do a review themselves.

Many existing investors will have accumulated a collection of fund holdings over the years that might no longer suit their needs or changing risk appetite.

Having an incorrectly balanced portfolio could result in losses in the case of a market shock in an area in which an investor might be overexposed. Experts recommend revisiting your choices once a year. But if your circumstances change then an extra review might be in order.

It is not just the investor's circumstances that must be considered. Things change in the world of fund management too. Fund managers move jobs and while a fund might be chosen because the manager has an excellent track record, it might be necessary to monitor the situation if that person leaves so you know your money remains in safe hands. If this happens it is certainly no reason to panic, but worth taking it into consideration during a review.

Funds that perform badly for a prolonged period might be worthy of the “sell” pile. Many savers are guilty of sticking with the same funds for decades and putting up with paltry returns unnecessarily.

The most important thing is to know that investment planning is not just a one off exercise. It’s a journey during which you need to keep checking you’re on the right track.

There are a number of investment options and providers out there, with a range of tools and services to help you make an informed decision about your investments and reach your goals.

7



Jargon buster

45

7. Jargon buster

Benchmark	A standard against which the performance of a fund is measured and compared.
Closed-ended	Where the number of shares of an investment is fixed
Fund supermarket	Also known as a platform or discount broker, an online company where an account holder can select, buy, sell and view funds from many different firms. They also deal in trading shares.
Gearing	Borrowing money to invest, with the aim of increasing returns. For example, if you invest £100 and make a 5% return you make £5. Borrow an extra £20 to invest and you make £6 (minus the cost of borrowing the money). However, with gearing comes a higher degree of risk. Whilst the potential for growth may be greater; losses may be more substantial too.

Index	A list of investments. For example, the FTSE100 is a list of the 100 largest companies in the UK with publicly traded shares.
Key Investor Information Document (KIID)	A compilation of key information about an investment fund. This is a requirement by the regulator and must be given to an investor before they place money into an authorised fund.
Open-ended investment company (OEIC)	A type of investment fund, structured as a company, that can create shares for new investors and which will buy shares back from an investor if they wish to sell.
Ongoing charges figure (OCF)	The fee for holding a fund each year expressed as a percentage.
Open-ended	New shares are created in response to investor demand.
Outperformance	Where the return of an investment fund exceeds that of its benchmark.

NISA	The New ISA or NISAs, as we now refer to them) replaced ISAs in July 2014. They can hold any combination of cash and stocks and shares.
SIPP	A DIY pension with a wide choice of investments and flexibility that is held with a fund supermarket.
Unit trust	A regulated open-ended investment
Underperformance	When an investment provides returns lower than that of its average – the benchmark.
Yield	The level of income paid by an investment given as a percentage of the value of that investment which could be in property, shares, bonds or cash.

For more information on Schroders funds, speak to our Investor Services Team on 0800 718 777* or visit us online at www.schroders.co.uk

For advice on investing, speak to a financial adviser.

You can find independent reviews of financial advisers at www.unbiased.co.uk or www.vouchedfor.co.uk

