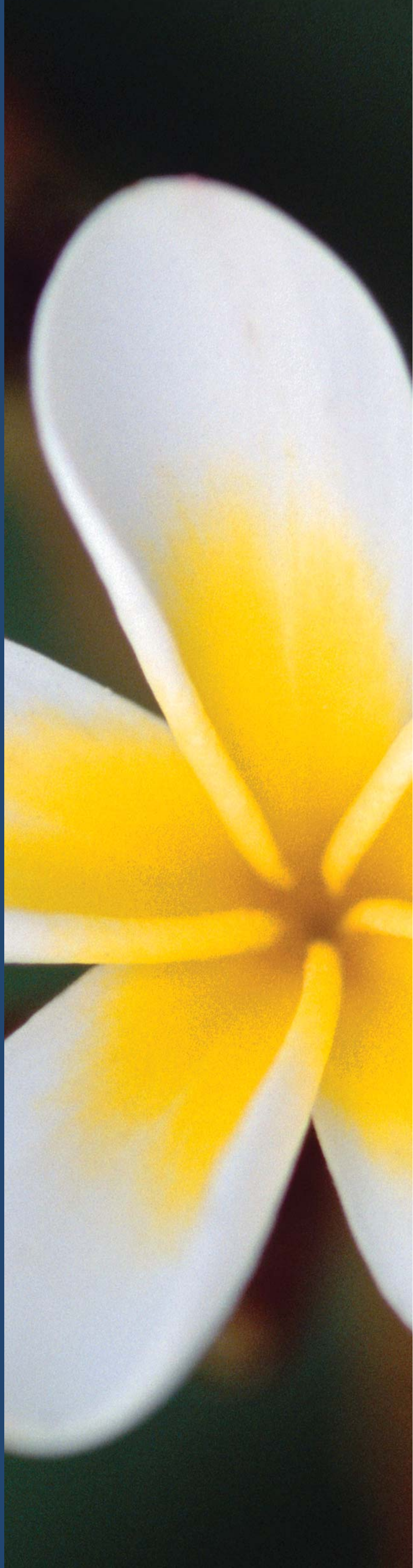
ghc capital markets



Understanding Investment Risk & Portfolio Construction

GHC Capital Markets Limited

Introduction

This guide has been produced to enable you to make informed decisions about your investment portfolio.

Who ever said ‘what you don’t know can’t hurt you’ is mistaken when it comes to investing. What you don’t know can hurt you, and it often will. You cannot eliminate risk when you invest, but you can understand it and take steps to maintain it at an acceptable level for you.

Despite the financial community’s search for tools to explain investment risk, the complexity of risk remains a daunting obstacle. There is no single investment approach or mathematical formula that will provide a comprehensive and guaranteed result. The best course of action is to assess your risk tolerance based upon your investment goals, financial condition, time frames and comfort levels.

There is a balance between risk and reward. Investing too conservatively to achieve your goals can be just as damaging as investing too aggressively.

About GHC

GHC Capital Markets Limited was established in 1996 as Investment Managers and Stockbrokers. Since then we have become known for our progressive attitude towards portfolio management, where we monitor and assess the rapidly developing trends in worldwide markets and increasingly complex financial instruments. The key to our success is our ability to work professionally and in partnership with you and your financial adviser.

GHC provide a full range of professional investment services, including discretionary and advisory investment management. These services can be provided within a range of product wrappers such as SIPPs, SSASs, ISAs, Onshore and Offshore Bonds.

Being totally free from ownership from any other financial organisation means that we are able to make investment decisions without the influence of a larger parent company. Having no external influences allows us to ensure that every decision is made in a client’s best interests.

Restricted Advice

If we give you advice, it will normally be on investments from a restricted number of products and product providers that we have assessed as suitable. We may also give you advice, in limited circumstances and only if you have asked about products and product providers which we have not assessed. As a result, our advice will be ‘restricted’ as defined in the FCA Rules and not independent advice as also defined in the FCA Rules. Restricted advice is advice that is not based on an analysis of products or investments from the entire range of products and providers. For Collective Investment Schemes such as OEICs or Unit Trusts we will continue to research and make recommendations from the whole of the market unless we inform you differently.
You should consider these restrictions carefully before deciding whether to use our advisory or portfolio services or advice and dealing service.

GHC Capital Markets is a member of the London Stock Exchange, authorised and regulated by the Financial Conduct Authority (FCA) and part of the GHC Group of companies.

Note that where an MSCI indices has been used for illustration , the date has been sourced with permission form MSCI Inc.

Understanding Investment Risk

All investment decisions involve a trade-off between risk and reward. Generally speaking, the greater the risk an investor is prepared to accept, the greater should be the expected reward.

There are a variety of risks that affect investments. We have highlighted some of the risks that we feel are important for you to understand and suggestions as to how they could be dealt with to minimise the impact on your portfolio.

Market Risk

This risk arises from the possibility that whole markets may decline. Equity and bond markets are influenced by a multitude of factors such as unexpectedly poor economic data or geopolitical developments. If the market enters into an extended period of declining prices (known as a bear market), all investments within that market are likely to be affected. It is possible that even companies with strong earnings and a sound financial position will still see their share prices fall under such circumstances.

The most effective solution in order to minimise this risk is diversification across a variety of asset classes, including equities, bonds (interest bearing debt), property & infrastructure as well as cash or cash equivalents – effectively, not putting all your eggs in one basket!

Credit Risk

Most investments involve credit risk of one degree or another. However, it has the most significance within the bond market. In the case of bonds, there is the possibility that the issuer will default on the interest payment, the principle repayments (capital repayments) or both. The majority of bonds have their credit worthiness monitored by rating agencies, such as Moody's or Standard & Poor's.

Higher quality bonds, such as those issued by companies with strong financial positions, tend to pose less credit risk than those issued by weaker companies. The lowest credit risk for UK based investors are British Government Bonds, known as Gilts.

The credit risk for equities is similar to that of bonds. If a company cuts or even suspends its dividend payments, it could cause the share price to fall dramatically.

The impact of credit risk in the bond market could be minimised by focusing on high quality investment grade corporate bonds or Gilts. In relation to other asset classes, such as equities, focussing on companies that have strong balance sheets and positive cashflows can reduce credit risk.

Inflation Risk

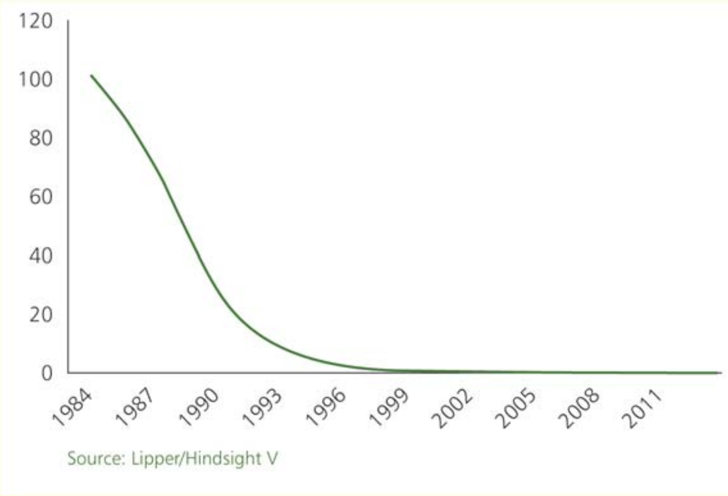
Inflation is the process whereby purchasing power is reduced, caused by the cost of goods and services rising year on year. This uncertainty of what your money will be able to purchase in the future is inflation risk. Even when inflation is low, which it has been in the UK over the last few years, its cumulative effect over the long term is significant. An annual inflation rate of 4% will cause your purchasing power to be cut in half in about 17 years.

It is especially important for investors who rely on their savings and investments to provide them with an income to be aware of inflation risk. One of the largest groups of investors that fall into this category is the retired.

To manage inflation risk an investor should select asset classes appropriate to their risk tolerance and time horizon that have historically delivered investment returns in excess of inflation.

Interest Rate Risk

Purchasing Power of £100 at start of 1985



Interest rate movements can have a major effect on investments, especially bonds that pay a fixed rate of interest, known as a fixed coupon. When interest rates rise bond prices would typically fall, and in an environment of falling interest rates they would typically rise. These price changes take place to re-align the interest paid by existing bonds with those of new bonds being issued to the market.

In general the longer a bond's maturity, the greater the sensitivity is to changing interest rates.

Moving interest rates may also affect equity prices but the historical correlation between interest rate changes and equity prices is less clear. However, it is clear that a company with large bank borrowings would suffer if interest rates went up, as the debt servicing costs would increase, potentially reducing profits. In addition, lower bond yields tend to improve the relative attractiveness of equities and other asset classes.

To mitigate the effects of interest rate risk within a bond portfolio, an investor should consider diversifying their investments across a variety of maturities.

Currency Risk

The currency markets can be volatile with large movements possible within a relatively short period of time. This could have a significant impact on the value of overseas investments for investors.

If the pound fell in the currency markets then the sterling value of overseas investments held within a portfolio would rise. Conversely a strong pound would see the value of such investments fall.

In general movements in the currency markets could affect all asset classes. Due to the advent of the global economy many British companies derive large proportions of their earnings from overseas trading activities, where these currency movements could impact their earnings, and hence their share prices.

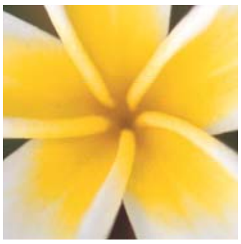
To reduce the impact of currency risk, especially for those requiring an income from their investments, an investor should consider retaining the majority of their portfolio in investments issued in their domestic currency.

UK Real Short Term Interest Rates

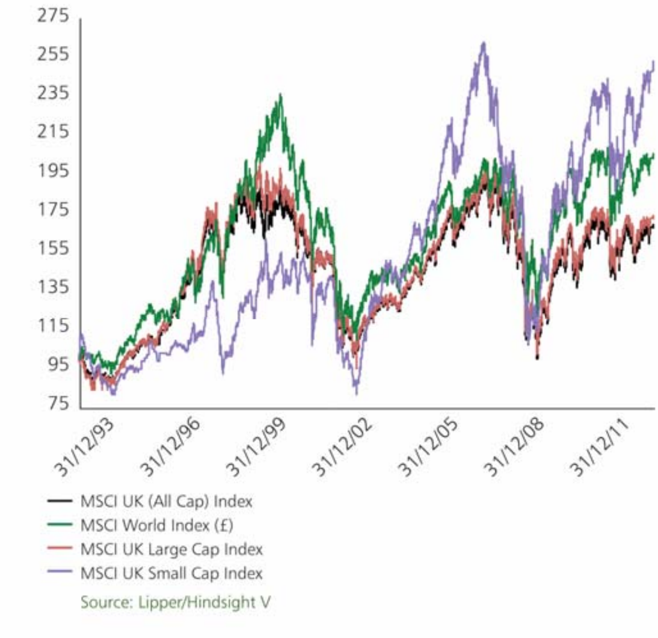
Legislative Risk

Government has the power to create or change existing laws affecting investments. By changing the tax consequences of owning equities, bonds or other investments subject to taxation, the market value of certain investments may change substantially. Changes in capital gains tax legislation could affect timing strategies concerning planned liquidations of investments, such as for retirement or school fees.

An effective way to reduce the potential impact of legislative risk is for investors to utilise their tax free allowances in every tax year.



MSCI Stock Market Indices Compared



Liquidity Risk

Being able to dispose of investments when the need arises may be critical to an investor. There are many reasons why investments may be sold. These could be a change in personal circumstances, such as retirement, or simply a change in the investment selection within an asset class. However, the primary concern of liquidity risk to an investor is whether or not they can raise cash if required.

Liquidity risk within the financial markets is normally due to the inability to find buyers for a particular investment. Ultimately, the price of any particular security is based upon supply and demand.

Investors wishing to minimise liquidity risk should concentrate their investments where large pools of liquidity are known to generally exist. In the case of bonds this will apply to those issued by the British Government as well as many of the high quality corporate bonds. Liquidity in equity markets tends to centre on the largest companies.

Diversification

Diversification is an important component to consider when investing. There is an old adage “do not put all your eggs in one basket”. This simply means that the process of spreading your investments over a variety of asset classes and individual investments reduces risk.

The Meaning of Diversification

Diversification means spreading your investments across a variety of asset classes as well as individual securities. The primary asset classes are equities, bonds, property & infrastructure, cash and cash equivalents. There are other asset classes that investors could consider, including commodities and private equity. In addition to these asset classes there are financial instruments known as ‘alternative investments’, which include hedge funds and structured products.

By diversifying an investment portfolio across various asset classes the risk can be significantly reduced. This is due to each type of asset class having different risks, rewards and tolerance to economic events. Investments where the prices are negatively correlated will see their individual prices move in opposite directions.
By blending assets that have historically low or negative correlations with each other, it is possible to reduce fluctuations in portfolio values, known as volatility, thereby reducing portfolio risk.

It is also possible to achieve investment diversification within asset classes. In the case of a single asset class, such as equities, an investor could acquire shares in a range of different companies across a spectrum of unrelated industrial sectors. Another strategy that provides diversification across a single asset class is to invest in other countries and geographic regions.

Systematic and Unsystematic Risk

Systematic risk is something that affects the market as a whole. Events such as inflation, war and interest rate changes influence the entire economy, not just a specific company or industry. Diversification within a single asset class cannot eliminate this risk and therefore it is considered un-diversifiable risk.

Unsystematic risk is specific to a single company. This type of risk could include dramatic events such as fraud, litigation or simply a poor trading performance. Two common sources of unsystematic risk are business risk and financial risk. Diversification can mitigate unsystematic risk from a portfolio. There is no reward for taking on unneeded unsystematic risk; investors are rewarded for taking market risk.

Total Risk of Investment

Unsystematic Risk

Potential variability in the returns offered by a security as a result of factors specific to a company, such as:

- *Quality of management*
- *Profit margins and cash flow*
- *Pricing power*

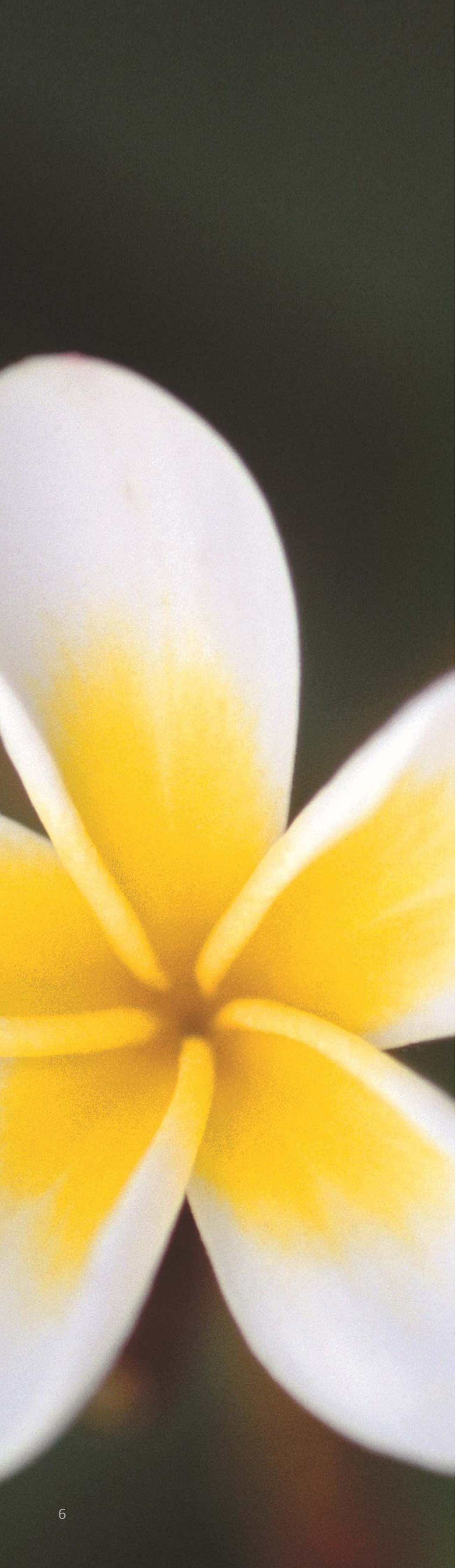
Can be eliminated through diversification

Systematic Risk

Potential variability in the returns offered by an investment caused by general market influences, such as:

- *Inflation rate change*
- *Interest rate changes*
- *The state of the economy*

Cannot be eliminated through diversification



Collectives

A collective is not an asset class but refers to certain types of investment vehicles, such as unit trusts, Open-Ended Investment Companies (OEICs), investment trusts and Exchange Traded Funds. They are sometimes known as mutual funds.

One of the main advantages of collective investment is the reduction in investment risk (capital risk) by diversification. An investment in a single security may do well, but it may collapse for a variety of reasons, due to unsystematic risk. If your money is invested in such a failed security you could lose the majority, if not all of your capital. By investing in a range of securities in a collective the capital risk is reduced. By way of example, a typical fund investing into overseas equities may contain between 50-100 individual securities.

Another advantage of these vehicles is that they can provide access to certain asset classes or a sub category (asset types) of one or more of the asset classes that may be inappropriate for direct investment. This may be in specialist or higher risk areas, such as equity in smaller companies, emerging markets or even unquoted private companies.

There are some collective investment vehicles that invest into foreign denominated or higher risk sterling bonds. Exposure to other asset classes may also be possible, for example commodities and property, allowing a greater diversification of asset classes within your portfolio, thereby reducing systematic risk.

The Importance of Diversification

It is clear that a diversified portfolio can significantly reduce the risk of investment. Diversification within a single asset class can help to eliminate unsystematic risk from a portfolio whilst diversifying among different asset classes that are negatively, or at least weakly correlated, reduces the volatility of a portfolio. Investment returns are 'smoothed' within a diversified portfolio as it limits the potential highs, as well as the lows. Diversification provides an investor with the greatest protection against business risk, financial risk and volatility.

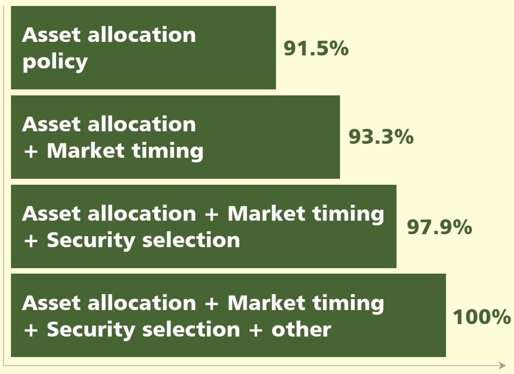
Asset Allocation

Asset allocation is the process of dividing your investments among the various types of asset classes that are appropriate for possible inclusion into your portfolio. At GHC the primary asset classes are equities, bonds, property & infrastructure, cash and cash equivalents. There are also a range of other asset classes that may be suitable such as commodities and private equity.

In addition to these asset classes there are financial instruments (securities) known as ‘alternative investments’, which include hedge funds and structured products.

There is a whole host of academic research suggesting that the correct asset allocation strategy is the key to successful long-term investment performance. For example, research by Brinson, Singer and Beebower[1], using data covering the 10-year period from 1977 onwards, showed that 91.5% of the variability in a typical investment portfolio’s performance over time was attributable to asset allocation.

Selecting the Right Asset Classes



Source: Brinson, Singer and Beebower [1]

The appropriate proportion, or weighting, invested in the different asset classes depends on a number of factors. These factors include your investment goals, time frame and attitude towards risk, each of which is individual and unique to you, the investor.

Understanding your position with regard to these factors will be of the utmost importance to your GHC client executive and your financial adviser, and will form the cornerstone of your investment portfolio. Further information is provided in the section “Constructing an Investment Portfolio”.

Equities and Their Characteristics

Equity investments are attractive for those clients who are prepared to accept significant fluctuations in the value of their investments over relatively short time frames in exchange for the prospect of longer term capital growth and, in the case of ‘value’ orientated shares, the prospect of a rising income from the dividends.

Amongst the primary asset classes, equities carry the most risk to your original investment. In order to construct a well-diversified portfolio of direct equities we believe there should be at least 15 securities, ideally with each in a different sector of the market.

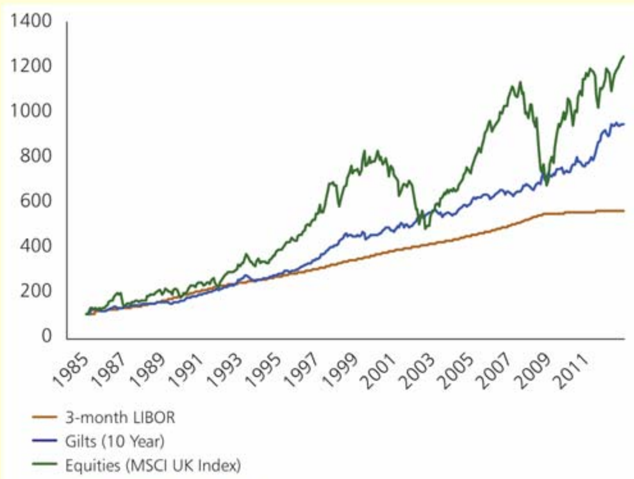
Generally, equities have displayed the highest volatility over shorter time frames but have offered the potential for greater returns over longer time frames.

Equities have also generated the highest inflation-adjusted returns over the long term and so have historically best protected investors from the depreciating effect of inflation.

Although many clients may be hesitant in exposing their investments to the potential volatility of equities, setbacks in the stock market have historically tended to be temporary.

Equity, Fixed Income & Cash Returns compared

Value of £100 invested on 31 Dec 1985, income re-invested



Source: Lipper, BoE, ONS, GHC

[1]Brinson, Singer BD & Beebower, GL, ‘Determinants of Portfolio Performance, An Update’, Financial Analysts Journal, May-June 1991.

Bonds and Their Characteristics

A bond is a debt instrument issued by a government, government agency or a company. The issuer of the bond agrees to pay back the loan by a certain date usually with a pre-determined rate of interest at regular intervals.

The majority of bonds have an interest rate, or coupon, that is fixed, and therefore are commonly referred to as fixed interest securities.

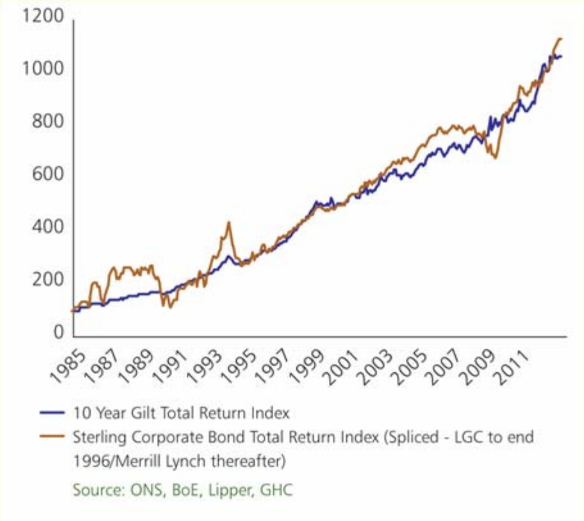
These fixed interest securities are attractive to clients who are looking for a fixed income and, in some circumstances, capital growth.

Typically these investments have less severe short-term price volatility than equities and therefore offer lower market risk. The regular income and relative stability of bonds may offset some of the volatility associated with equities.

Because the income from bonds is fixed in nominal terms, relative to equities, they tend to have a higher inflation risk and their potential return over the longer-term is therefore lower.

Total Return on Gilts & Corporate Bonds

Index Jan 1985 = 100



UK Commercial Property, Equities & Gilts Compared

Rebased End December 1986 = 100

Property & Infrastructure and Their Characteristics

As an asset class, property & infrastructure provides a good method of diversifying a portfolio, as it tends to have a low correlation to both equity and fixed interest securities. Due to the high cost of purchasing individual properties and infrastructure schemes, for most individuals investment is made via collectives. This route also offers diversity by providing exposure to a wide range of property types including retail, office and industrial.

Although property & infrastructure can offer the potential for capital appreciation, one of the key characteristics of this asset class is the relatively stable income yield. Historically this has been the main constituent of its overall return, making it particularly attractive to those seeking income from their portfolios.

Cash and Cash Equivalents and Their Characteristics

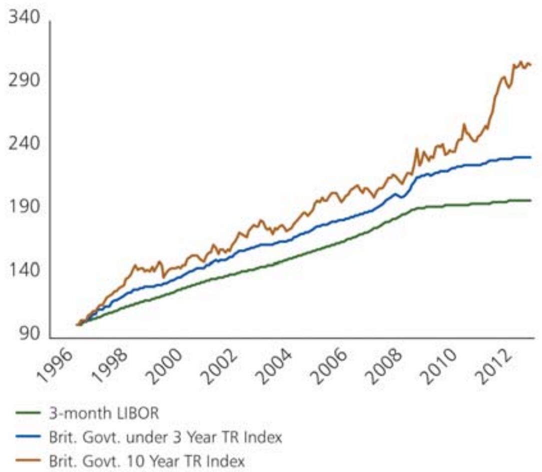
The advantage of cash is that it cannot lose its capital value and is readily realisable. However, cash and cash equivalents also has the highest inflation risk that erodes the real purchasing power over time. As a result the long-term investment returns for cash have been the lowest of the primary asset classes.

Cash equivalents tend to be money market instruments and ultra short dated bonds that share the same characteristics of pure cash, namely capital preservation. Where these instruments are suitable for your portfolio, exposure will normally be obtained through specialist collective investment vehicles.

In addition to inflation risk there is also credit risk, as a deposit taking institution may be forced to go into liquidation, with investors possibly being unable to recover their full investment. Whilst this is uncommon there have been cases, such as BCCI and Barings.

Cash Returns against Gilts

Value of £100 invested on 31 Dec 1985, income re-invested



Source: Lipper, ONS, BoE, GHC

Commodities and Their Characteristics

The commodity market is made up of three broad sectors, agricultural, metals and the energy markets. Agricultural markets trade in a wide range of goods including grain, livestock and coffee. Gold, silver and platinum are all traded in the metal market together with base metals such as copper and zinc. Energy markets trade in natural gas, oil and power.

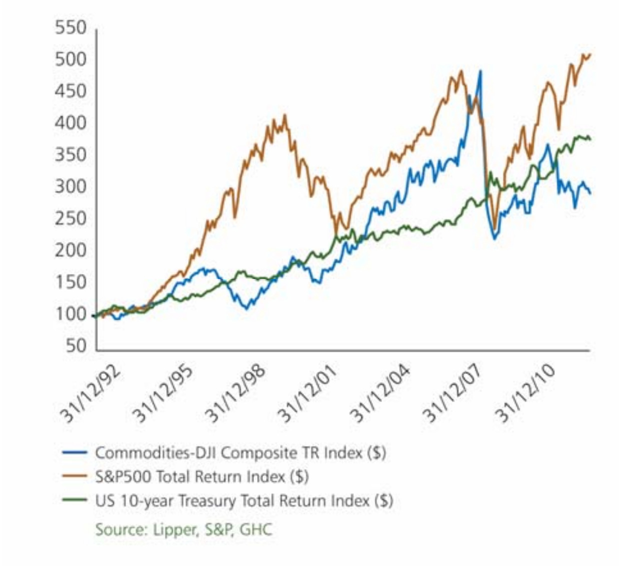
Historically commodities provide a potentially useful method of diversifying a portfolio, as it tends to have a low correlation to equities and bonds. Other characteristics, in contrast to the primary asset classes, is that an investment in commodities offers no income yield and is therefore only suitable for the potential of capital growth.

Commodity prices can be very volatile and therefore investment in this area tends to carry a high degree of risk.

For the individual investor, due to the high costs of transportation and storage of physical commodities, exposure to this asset class is only available through collectives.

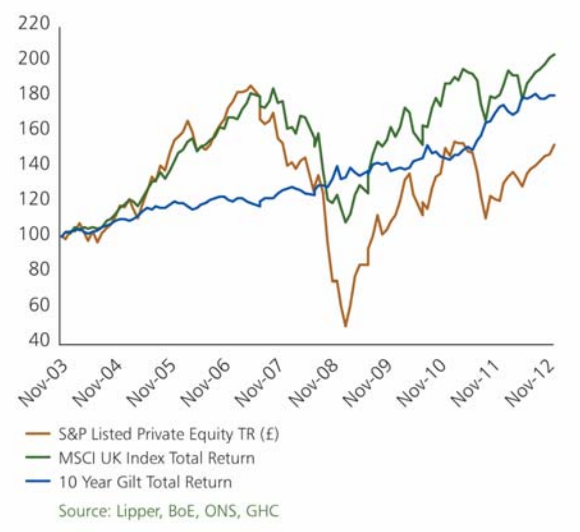
Commodities, Equities & Bonds Compared

Rebased End December 1992 = 100



Private Equity, Equities & Gilts Compared

Rebased End December 2003 = 100



Private Equity and Their Characteristics

For the majority of investors, equity investment focuses on companies listed on recognised stock exchanges such as the London Stock Exchange. However, there are many privately owned (unquoted) firms that are not listed on a stock market.

Private equity is medium to long term finance provided by institutions to private companies in return for an equity stake to fund growth and expansion plans.

It is estimated that private equity firms are now financing more than 1,600 UK businesses a year. In many cases private equity focuses on start up and early stage companies, often referred to as venture capital. Private equity can include investment in more established unquoted companies where for example there is a change of ownership via a management buy-out.

Private equity investment can offer the potential of high returns, but equally the risk is also very high as some firms can and do fail. As well as the unsystematic risk there can also be a high degree of liquidity risk, as shares are not traded on the recognised stock markets.

Hedge Funds and Their Characteristics

Conventional funds move broadly in line with their relative market, making profits as the market rises and declining in value as markets fall. In contrast, a Hedge Fund aims to deliver a profit (absolute return) in all market environments. This potential to deliver positive returns under all market conditions means that they aim to achieve a low correlation to the traditional asset classes, although this is not guaranteed.

Indeed, there has been a tendency for some hedge fund managers to employ sophisticated and risky investment techniques that have lead to large losses and even a total loss, referred to within the investment community as a ‘wipeout’.

Hedge funds tend to have limited transparency and therefore can be difficult to evaluate and monitor. Liquidity can also be an issue as some managers impose ‘lock-up periods’ where they prevent investors from redeeming their shares or impose penalties if they wish to redeem. Many hedge funds are also unregulated providing an investor with less protection.

Due to a variety of factors, hedge funds should in the main only be considered by investors that are prepared to accept a high degree of investment risk.

Structured Products and Their Characteristics

Recent years has seen a rapid growth in the structured product market. Structured products are ‘synthetic investment instruments’ that utilise derivatives, which are passive in nature and focus on providing returns with some element of capital protection. Returns on these products are linked to the performance of the underlying asset that it represents. Typical underlying investments are baskets of equities, indices or commodities.

Most structured products have been designed to have a fixed life of between 3 to 5 years where the ‘protection’ is only provided if held to maturity. If an investor wishes to make an early encashment there is no guarantee that there will be a willing buyer.

As ‘protection’ is not a guarantee there is a risk that the capital (or income) entitlements will not be paid if the investment bank supplying the derivative defaults. This default risk can be assessed by the credit rating of the investment bank, where the higher the credit rating then the less risk of default.

In summary structured products are often marketed as means of reducing risk; however the reality is in most cases that the product will still be subject to a number of the risks outlined above including market risk, credit risk and liquidity risk.

Hedge Funds, Equities & Gilts Compared

Rebased End December 1993 = 100

Constructing an Investment Portfolio

Before we can construct a successful portfolio there are a number of important pieces of information that we need to ascertain about you.

These are your financial condition, investment goal, time frames and your comfort levels. We will also ask you to provide us with your views on the range of assets that should not be included in your portfolio. The sum of this information will allow us to ascertain the most appropriate risk tolerance for you.

This process may also highlight conflicts between the information that you have provided to us and your stated investment goals, risk tolerance or both.

Under such circumstances we will ask you to reconsider these conflicting elements in order to allow you to arrive at a more realistic conclusion.

Ultimately the decision to invest is yours. This will also apply to the asset allocation of your portfolio. GHC, in conjunction with your financial adviser, will provide as much advice and guidance that you may need to empower you to make an informed decision regarding your investments.

Financial Condition

Before you consider any investment it is important to ascertain what you can afford to invest. The two areas to examine are your income versus your expenditure and your assets versus your liabilities.

Income is typically used to finance your day-to-day cost of living. Everyone is an individual and as such the actual amount required to live varies from person to person. GHC cannot advise clients on their lifestyle and it is your responsibility to realistically assess the level of income that you require to match your expenditure.

The source of that income, including the reliability that it will continue, is another major factor that should be considered.

Examining your assets versus your liabilities will enable GHC and you to establish your net worth. The information you provide has wide reaching implications and could result in GHC offering you a variety of investment solutions.

Where there is a high amount of debt perhaps the most significant implication is how the liabilities will be financed or repaid. In the case of significant net assets the most significant implication may be tax sheltering or tax efficiency.

Investment Goals

The three basic requirements of any investment product are income, growth, or a combination of the two, sometimes referred to as balanced.

Income is the most important objective to some clients whilst to others it has little or no significance. Many of our clients who have retired are interested in achieving the highest possible income from their portfolio within their risk tolerance.

Clients need to be aware that if they take a high income now, the probability will exist that there will be less income available in the future. This is due to the possible effects of inflation eroding the capital base over time.

Counteracting the effects of inflation may require some of the income reinvested to preserve the real purchasing power of the capital base or alternatively some of the capital could be invested for growth.

Clients must ascertain if they require a high level of income now with limited prospects of capital growth, a lower income now with greater prospects of future growth in income and capital, or growth in capital rather than an immediate income.

Time Frames

This allows us to establish when you may require access to your investments, whether it is for an income or to finance a large capital expenditure.

The rule of thumb is that the longer you are able to keep your money invested the more risk you are able to tolerate. This is due to the ability of your portfolio to withstand short-term fluctuations in its value.

Short-term investments are described as being up to 5 years. The types of investments that you should consider for this time horizon are those with little to no volatility, such as those that fall into the asset class of cash and cash equivalents. This should remove the risk that your investments will be worth less in the future than today.

The choices available to investors that are able to invest for the longer term, five years and above, are much wider.

Equities can and, in most cases, should be included in your portfolio. The longer the time horizon the more you may wish to consider increasing the proportion of your portfolio invested in equities.

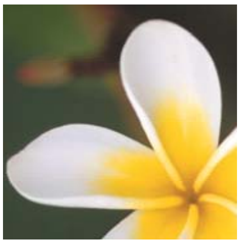
Comfort Levels

There is an old adage used by American investors, which states “sell down to the sleep level”. In other words, what is the appropriate mix of assets that would allow you to sleep at night?

This part of our ‘Investor Appraisal’ will allow us to assess your natural level of risk tolerance. Some individuals are prepared and enjoy taking large risks, may be even to the point of speculating rather than investing. Others are naturally cautious and can only tolerate small amounts of risk.

Risk Tolerance

In conjunction with your investment objective, the level of risk tolerance will help determine the proportions of your portfolio that will be held in the main primary asset classes, equities, bonds, property & infrastructure, cash and cash equivalents. What matters is that you understand the nature of the risk so that we can construct your investment portfolio, whilst you understand and accept the possible consequences.



Monitoring

Once your portfolio has been agreed and constructed, it is equally as important that it is frequently monitored, thus ensuring that your risk tolerance and investment objectives are maintained.

Over time, without monitoring, the effects of market movements will naturally lead to your portfolio becoming unsuitable, with the relative exposure to the suitable asset classes no longer appropriate to fulfil your investment requirements. This effect is known as ‘market drift’.

The importance of monitoring is also true of the individual securities that form a part of your portfolio. An individual security that is appropriate for you today may not continue to be at some point in the future. There may be circumstances where there is a more suitable or attractive security that could replace the existing one. It could simply be that a single security has performed so well that the exposure to your portfolio to this individual security is deemed excessive.

Finally, in conjunction with your financial adviser, it is important to monitor that your financial condition, investment goal, time frames and your comfort levels have not altered. We will constantly communicate with you to ensure that your risk tolerance and investment objectives are still appropriate for you.

Where a change is identified, GHC and your financial adviser will advice you of your choices, responding with a flexible, efficient and caring approach.

Together, by working in partnership with you and your financial adviser, GHC aim to ensure that your unique requirements continue to be fulfiled.

Risk Warnings

This document does not constitute investment advice for the purposes of the Financial Services and Markets Act 2000. If you require investment advice regarding your individual circumstances, please contact us.

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