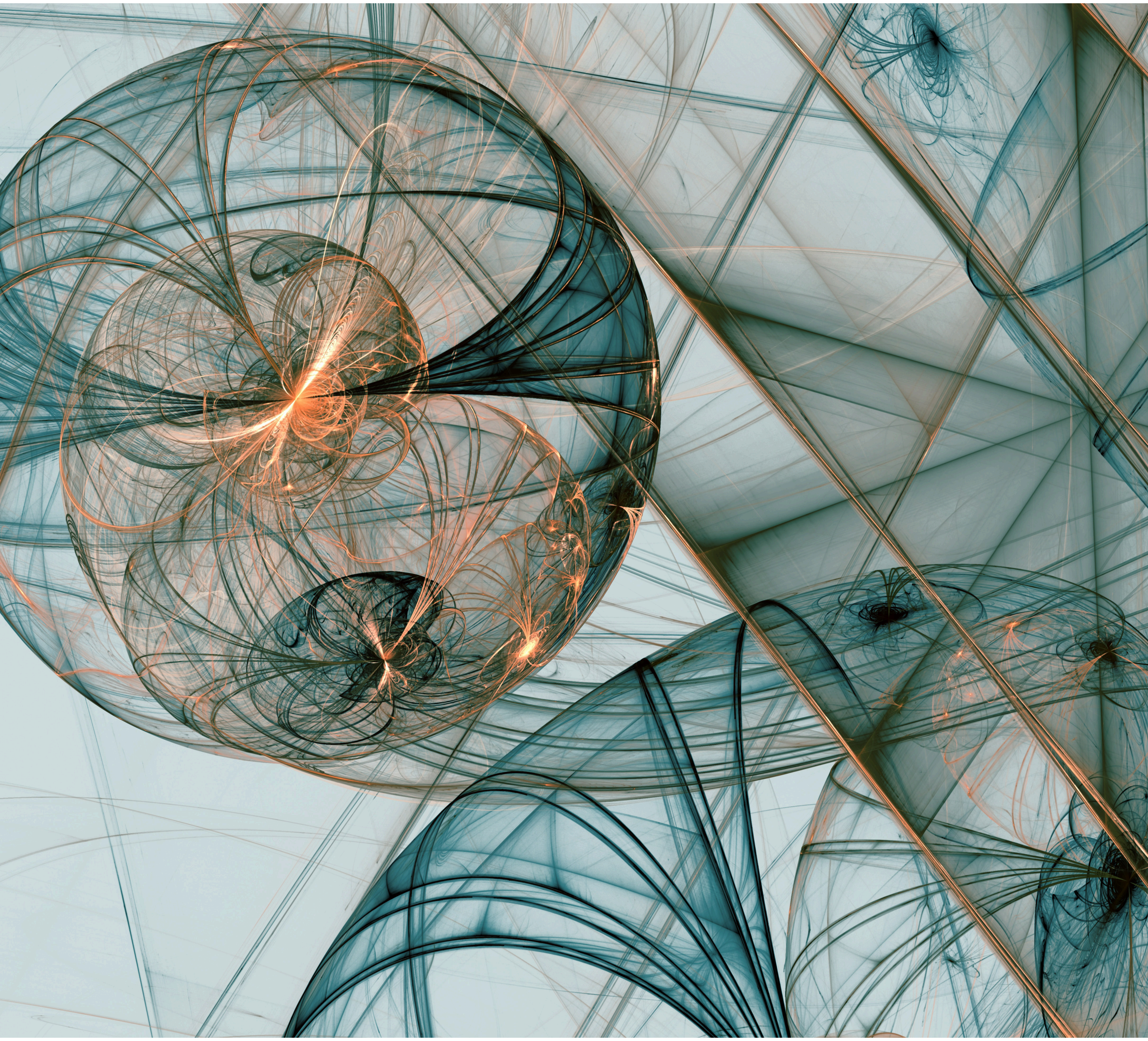
Collingbourne
Wealth Management



Six Principles of Investing

www.collingbourne.com

Introduction

This paper describes the six principles of investing that underpin our investment process which has served Collingbourne's clients so well. It draws upon an enormous amount of international academic research, which we keep under constant review.

At the end of the section on each Principle you will see an Action Point to take away.

But before all this, any investment you make should start with the end in mind and be integrated with your wider planning. Your Investment Plan is the 'engine' which will drive your Financial Plan to achieve or maintain your desired lifestyle. This means that before you apply our Six Investment Principles to build your engine, you should already have become very clear about the life journey you want to take (your Lifestyle Plan) and the resources available or needed to achieve this (your Financial Plan).

Evidence-Based Investing

To safeguard and grow our clients' wealth, we make investments based on evidence, not hope or guesswork.

Our investment process is based on the insights provided by leading, Nobel-prize winning academic theory and the evidence provided by decades of market data. We ignore the conventional wisdom and the noise generated by a self-serving investment industry and a media looking for a story to sell; we focus on what is important **AND** what can be controlled.

We have been investing through a systematic, evidence-based process for over 15 years, over which time our clients have enjoyed a highly successful experience. When we began, we were unusual, but now our way of investing is normal for large institutional investors around the world.

Our evidence-based approach focusses on the following 6 principles;

1. **Risk and Return are Related**
2. **Set a 'Risk Budget'**
3. **Set an Efficient Asset Allocation**
4. **Stay Disciplined**
5. **Diversify**
6. **Control Costs & Tax**

1. Risk and Return are Related

There are of course different kinds of risk. Examples include inflation, which erodes the buying power of money over time, or the possibility of missing a long-term financial goal, such as being able to afford to retire by a certain age. Risk could be that your company goes bust, your house burns down or you fall seriously ill.

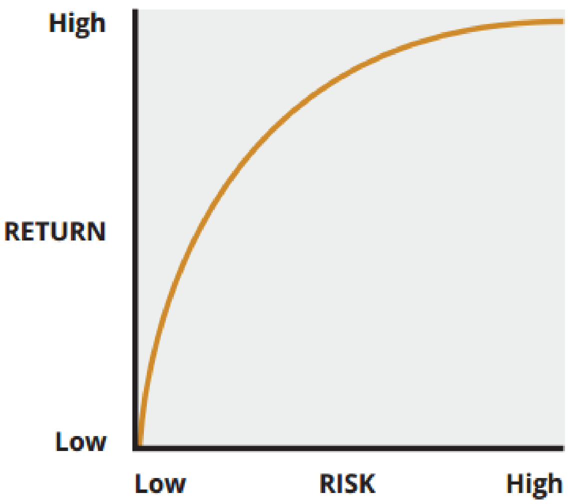
However, in the context of investing we refer to ‘risk’ as volatility, which is the amount an investment fluctuates in value.

The basic principle is this; **in order to get a higher expected rate of return, you must accept a higher level of risk.**

Low risk investments offer low returns because investors who cannot, or prefer not to, take much risk will accept less return in exchange for greater certainty. Risky investments have to offer the prospect of higher returns to entice people to invest. Unfortunately, the risk can materialise, which means investors may lose some or all their investment.

An important consideration in appreciating this principle is that **one person’s investment return is someone else's cost of obtaining capital**. So, if it looks too good to be true, it probably is. If it was such a sure thing, why are they offering such a high return / selling it to you so cheaply? If it was indeed safe, they could obtain capital more cheaply and keep the return themselves – people don’t deliberately give up more return than they must.

Over the last decade or so, we’ve seen no shortage of investment schemes that promised high returns with low risk fail, costing their investors most or all their money. The biggest and most famous example being Bernie Madoff, who managed to con roughly $65 billion out of professional / experienced investors into a pyramid scheme. More recently we’ve seen the collapse of property finance and peer-to-peer lending schemes promising double-digit returns.



This chart illustrates the relationship between risk and return. Different types of investment will tend to lie on the curve, with higher return investments involving greater risk and lower risk investments offering lower returns.

Investors must accept more and more risk for every extra unit of expected return. We call it "expected" return, because it is in the future and not guaranteed.

Whilst there are no investments that occupy the low risk, high return space to the top-left of the chart, there are investments that sit below the curve to the bottom-right, offering lower expected returns and higher risk. This will be touched on under principle 3.

Action Point: Do not invest in schemes promising high returns and low risk.

2. Set a 'Risk Budget'

The first and probably the most important decision you must make when investing is, **"how much risk should you take?**"

This clearly isn't an easy decision to make. Firstly, risk it isn't completely straight forwards to quantify, even if you can conceptualise a broad approach, between low and high risk, that you wish to take.

At Collingbourne we have a proven process of answering this question; we create an investor's **'Risk Budget'**, by looking at three main areas;

- Emotional tolerance to risk
- Financial capacity to accept risk
- Return requirements

Each of these elements is independent of the others. We've seen too many industry questionnaires which attempt to combine all three to arrive at a quick answer. In reality, these elements can conflict with each other and this needs to be consciously addressed and dealt with.

Emotional Tolerance: Your emotional responses towards risk are key; you need an investment strategy that you can stick with throughout market conditions.

Financial Capacity: How much risk you can afford to take, i.e. how much you would be financially affected by a fall in the value of your investments. Would your lifestyle or financial security be impacted?

Return Requirement: What rate of return do you actually need to achieve your financial objectives? This can dictate the amount of risk you need to take.

We assess each of the above for our clients and guide them to an appropriate allocation between safer 'defensive' investments and higher risk 'growth' investments.

A proper appreciation of an investor's full financial circumstances is usually required to address the second and third elements. A simple questionnaire does not normally do this justice. This is an area where an investment plan integrated within your financial plan can make a huge difference.

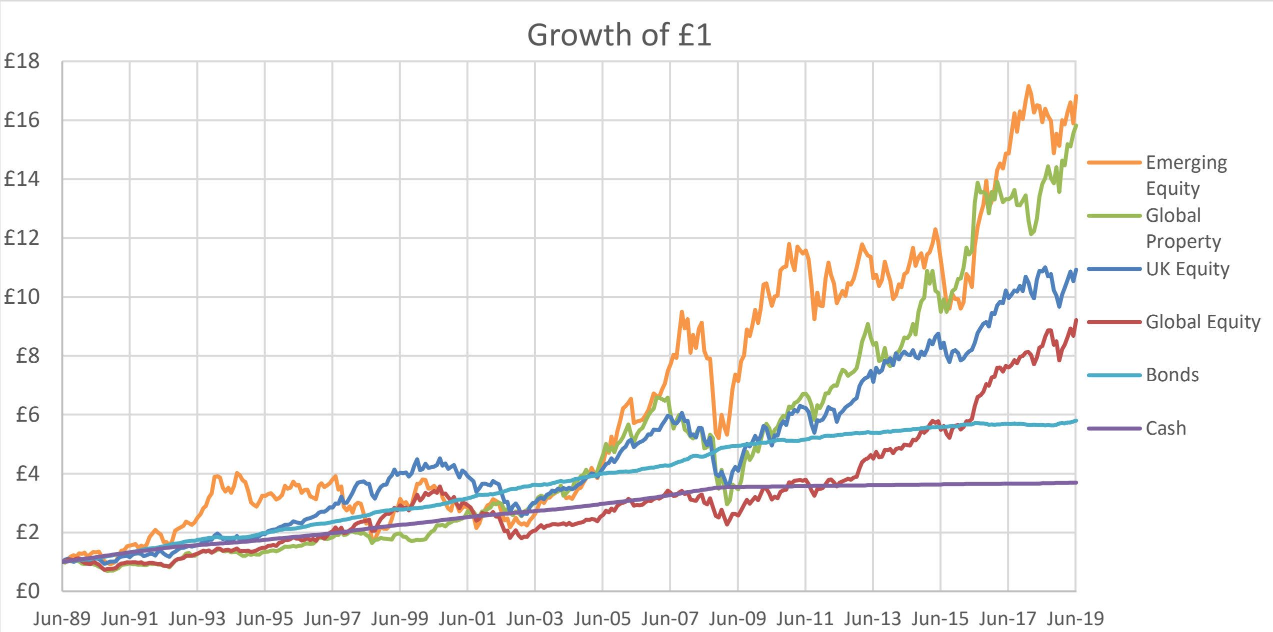
Action Point: Decide how much investment risk you are willing, able and need to take.

3. Set an Efficient Asset Allocation

Having set a 'Risk Budget' you need to use that budget as efficiently as possible. That means obtaining as much expected return as possible, for the level of risk you have chosen to take. If we consider the chart at the bottom of page 2, that means choosing a point on the curve determined by your chosen level of risk.

We refer to a group of similar investments, which can be expected to behave in broadly similar manner as an "Asset Class". Asset Classes can be grouped broadly, such as Cash, Bonds, Property and company Shares, and they can also be divided into narrower groups, such as shares grouped by region or company size.

Different asset classes, such as shares and bonds, behave differently to each other. Here are some asset classes and their historic performance over the last 30 years[1]:



It isn't about choosing the "best" asset class. If you knew which was going to be the best performer next year you would invest all your money into that one (and get out before it falls). No one has been able to consistently pick the winners in advance.

The aim is to select a mix of asset classes, which when combined, will give the maximum amount of expected return per unit of risk. Again, we are talking about 'expected' return. We can only know the most efficient asset allocation – what combination forms the gold line from that first chart – for historic periods.

It is a challenge to decide which asset classes to use (and which to leave out) and what proportions to combine them in. We consider the latest academic investment theory (i.e. the explanation and

[1] Data sourced from Dimensional Returns programme. Total return, income reinvested. Asset classes represented by indices, gross of costs and not available for investment.

logic of what is driving risk and returns) in combination with the evidence provided by decades of historic market data.

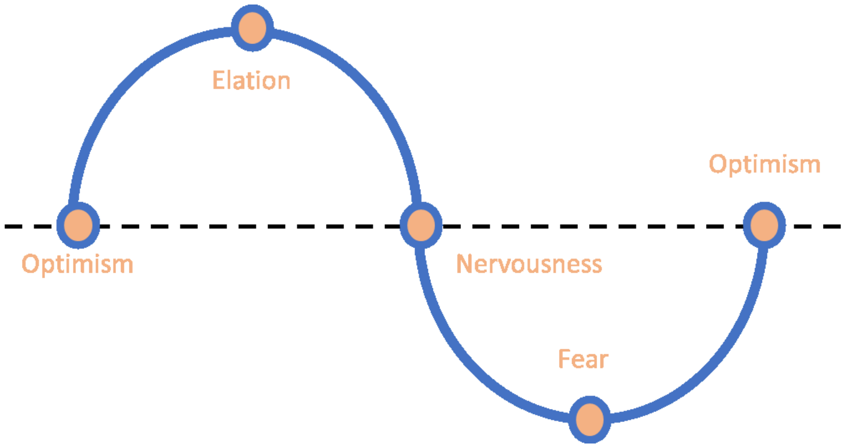
The decision over how to allocate investments between different asset classes will typically decide more than 80% of the risk and return of a portfolio. It is a far more important choice than deciding which investment manager to use, but usually receives less attention.

Action Point: Carefully select and allocate your portfolio between the right proportions of asset classes to achieve your risk and return objectives

4. Stay Disciplined

This is one of the most crucial aspects of a successful investment plan, but also one that is most difficult to get right. Investors around the world consistently fail to achieve this and the results can be very damaging.

Everyone knows the adage ‘buy low, sell high’. However, our human emotions are hard-wired to make us do the opposite. People struggle to separate their emotions from investment decisions and end up following the below cycle of investing;



As investment markets increase people feel more and more optimistic. They see the returns that are being made by others out there and greed sees them taking on more risk, buying in at higher prices. Then when markets fall, nervousness and fear set in and people panic and sell at lower prices. The cycle then repeats.

We find that it is often the most engaged and most intelligent investors that struggle with the cycle the most. Professional investment managers are also far from immune to emotional decision making. It is usually our clients who are least engaged / concerned about their investments that maintain their discipline and avoid the emotional cycle of investing.

Decisions investors make during periods of extreme market volatility can destroy wealth. These are the times we are most important to our clients; when we stop them making these decisions and enforce a disciplined investment process.

This is not a just a concept, it is a proven the world over. In the US a firm called Dalbar conducts an annual report, comparing the returns investors receive on each dollar invested compared to the actual returns of funds they invest in. The reports consistently demonstrate that investors collectively underperform their funds (which themselves, on average, underperform markets after costs) by significant amounts each year.

Dalbar’s 2018 report showed that US equity investors lost on average 3.6% p.a. compared to the market average over 10 years and that bond (fixed income) investors lost on average 2.8% p.a.

over the same period. The majority of this underperformance was attributed to investor timing decisions[2].

Given the above, a reasonable question would be how to avoid making the same mistakes as everyone else. The answer is to maintain a disciplined investment process. Having selected your asset allocation, you should stick to it. The different asset classes in your portfolio will naturally grow at different rates. You should periodically (e.g. annually) reset or 'rebalance' your portfolio back to that original allocation. This requires selling assets that have delivered higher returns over the previous period and buying the assets that have delivered the lowest returns. This should be done regardless of market conditions. Doing this regularly builds discipline.

Furthermore, you should avoid the latest investment fads and remain sceptical. Only change your approach when there is powerful new evidence - which doesn't come up as often as people think. "This time is different" are some of the most expensive words in history!

Action Point: Maintain a disciplined investment process. Stick to your chosen asset allocation. Only make changes based on new evidence, not market conditions.

[2] DALBAR Inc. QAIB (Quantitative Analysis of Investor Behavior) 2018. Average equity fund investor return of 4.9% p.a. compared to 8.5% p.a. for S&P 500 Index. Average fixed income fund investor return of 0.5% p.a. compared to 3.3% p.a. for Bloomberg-Barclays Aggregate Treasury Index. Data as at 31st December 2017, total return basis.

5. Diversify

Diversification was described as "the only free lunch in finance" by Nobel Laureate Harry Markowicz. Simply put, it means not having all your eggs in one basket.

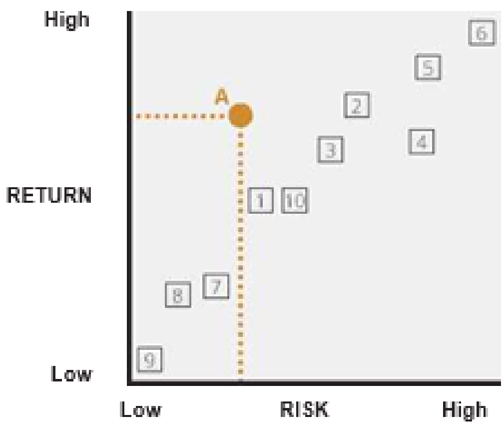
Setting an efficient asset allocation, will have ensured that you have diversified between asset classes. By using different asset classes which fluctuate in values at different times, portfolio risk will be reduced.

Diversification within an asset class means spreading your investments across a number of holdings within that assets class, such as having more than one share in your share portfolio, or more than one property in your buy-to-let portfolio.

Every investment has two types of risk; the risk of the asset class as a whole and the risk of the individual investment. For example, BP shares have the risk of the UK stock market - and will broadly rise and fall with it - and the individual risk associated with BP e.g. response to the Deep Horizon disaster.

The asset class risk has an expected return associated with it. The individual investment risk has no expected return above the market rate – you are not rewarded for accepting it.

Adding more holdings diversifies the individual risk of each investment. This reduces the risk of your portfolio, without reducing expected return. Therefore, it makes sense to invest in a large proportion of an asset class, rather than just a few individual holdings within it.



Using company shares as an example, this chart shows how asset class "A" of all shares (1-10) had a better historic risk-adjusted return than any of the individual shares within it.

In this example only three shares had a higher return than asset class A, but seven had more risk.

In the future the shares may behave very differently. You may expect share 1 to perform better moving forwards, someone else may believe share 4 will be the best - there is an inherent risk in picking one winner. No one can accurately predict the future; however, we can expect asset class A to have a better risk-adjusted return than the individual shares within it (i.e. be closer to the top left corner of the chart).

Historically investors have selected individual securities or hired stockbrokers to select them on their behalf. Collective funds such as unit trusts allow investors to combine their money with many other people to share professional management. There are thousands of funds of varying quality and cost, representing all asset classes.

More recently, funds have become available which allow investors to gain highly diversified exposure to a wide range of asset classes at much lower cost than traditional managed funds.

Action Point: Use a highly diversified quality fund to gain access to an asset class, rather than buying a few individual securities within the asset class.

6. Control Costs & Tax

It may sound obvious, but put simply, every £1 in costs is £1 off returns and your investment's value. The longer investments are held, the greater the cumulative effect. Even moderate increases in costs, when compounded for many years or decades can add up to big differences.

The chart below shows the impact of differing annual rates of total costs on a £10,000 investment growing constantly at 7% a year (gross) over an investment term of 30 years.

We can see the end value of the 2.5% Cost portfolio is well below half the value it would be without any costs deducted. The end value of the 0.5% Cost portfolio is a massive 77% (£28,690 / £37,453) greater than that of the 2.5% Cost portfolio.

There are multiple potential sources of cost associated with investing. It is the **total cost of investing you need to focus on** (including any initial or exit costs), not just headline management charges.

When investing, you can't (largely) control performance and future returns – markets will always fluctuate, and no one can predict precisely how. It is vital that you control what you can, of which costs are an important factor.

You may be thinking when it comes to investment management you get what you pay for. Pay for a premium service, get a premium outcome. Whilst this is certainly what the investment industry would like you to believe, the reality is somewhat different.

As always, we look at what the evidence shows us. Market studies have found that;

- No more investment managers outperform (after costs) than would be expected purely by chance
- There is no reliable way of predicting which managers will outperform in the future - funds that have previously outperformed cannot reasonably be expected to outperform in the future (after costs)
- The higher the cost of an investment fund (both explicit charges and implicit costs), the greater the chance that it will underperform

Simply put, high costs become a hurdle which investment managers can't jump.

As with costs, every £1 lost in taxation is £1 lost from your **net** return. There are a variety of allowances and tax vehicles (e.g. ISAs – Individual Savings Accounts) that can be utilised to minimise tax liabilities.

Tax allowances include the Personal Allowance, Personal Savings Allowance, Dividend Allowance and Capital Gains Tax (CGT) Annual Exemption,

The above allowances can reduce the tax liability on taxable investments. Where possible, it may make sense to hold investments in specific vehicles which confer special tax statuses. The most common are ISAs, Pensions and Investment Bonds.

It may make sense to allocate certain investments or asset classes to each of the tax vehicles used e.g. someone who invests through an ISA and a taxable account may wish to hold more of their shares in their taxable account, using their dividend allowance and CGT annual exemption, and more of their bonds in their ISA, as their personal savings allowance may be used by their cash accounts (or lost if a higher earner).

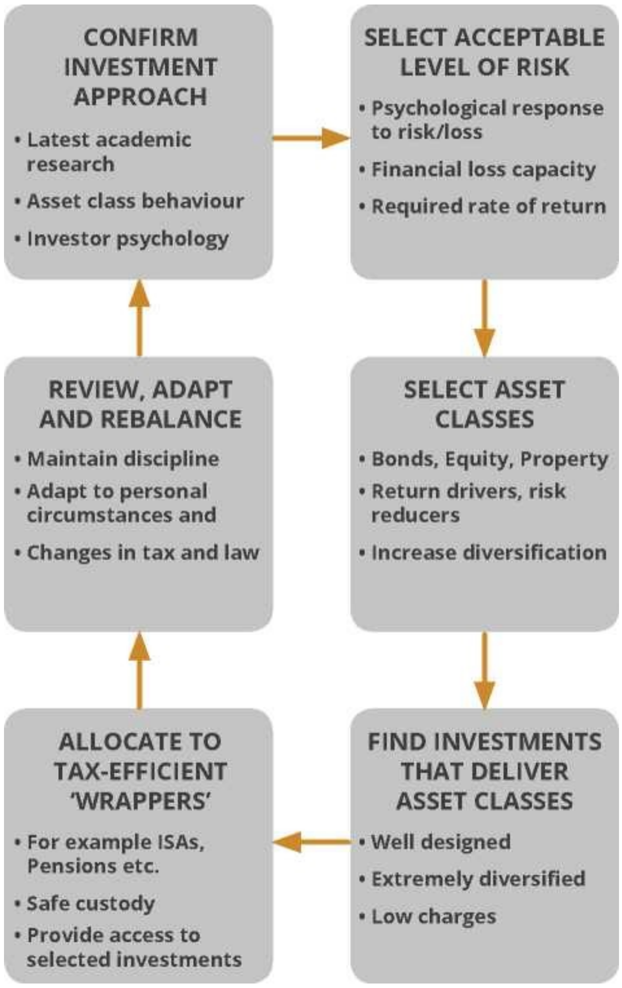
Making use of available tax allowances and choosing how much to allocate to different tax vehicles e.g. how much to contribute to a pension, should be undertaken as part of wider financial planning, structuring financial affairs in the most effective manner to achieve objectives.

Action Point: Minimise costs as far as practically possible, considering all sources of cost. Don't pay expensive management fees in the hope of superior performance. Make use of available tax allowances and efficiently use tax vehicles.

Putting it Together

Delivering a successful investment experience requires putting these principles into action through a process which is robust, repeatable and adaptable. Once in place, it is a virtuous circle which delivers clarity and control.

Below is the investment process Collingbourne guides its clients through to achieve this. *N.B. there happens to be six steps in this process - they do not directly correspond to the six principles on a one to one basis.*



"For the simplicity on this side of complexity, I wouldn't give you a fig. But for the simplicity on the other side of complexity, for that I would give you anything".

This investment process is both simple and sophisticated. It has stood the test of time to deliver a successful investment experience as an integral part of our client's strategic financial plans.

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