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Making investments clearer

‘Making investments clearer’ – a guide for you.

This guide is designed to support the fund information available to you through our websites and fund guides. It provides some additional information on the risks associated with making investments. It also gives definitions for the terminology used to describe funds and their features. This guide is intended as a summary of the key points and is designed to be read alongside our fund factsheets. It is not a comprehensive fund guide.

Understanding risk

The extent to which you are prepared to risk losses on the money you invest in return for the gains you might make will be one of your key considerations when making investment choices. No one invests expecting to lose money, but even so it is one of the risks and understanding that risk is the first step to successful investing.

Investment funds go up and down in value – some more than others. If, when you come to cash in your investment, it is down in value it may be better to wait until the value recovers. That’s why many investments are best considered over a longer period with no fixed end date in mind.

Most investors will have an attitude to risk ranging from cautious through to the more adventurous. Cautious investors tend to look for more stable returns and accept that the amount they are likely to gain will be limited as a consequence. On the other hand, more adventurous investors, seeking higher returns, understand that their investment is likely to go up and down in value at times quite sharply.

Your financial adviser will normally help you to understand your own personal outlook and this may change over the years so it is important to review it from time to time.

All investment funds carry some risk – the risk that the value may fall, as well as the risk that the value may not increase by as much as hoped. But with risk comes the potential to gain and successful investing means matching the gains you hope to make with the risks you are willing to take.

Investment funds have an objective and investment policy that explain the types of assets and areas of the world they invest in. This helps advisers and investors to assess the potential gain and risk within a fund.

Investment funds seek to maximise the potential gains for a given level of risk. A fund that seeks the highest gains will always carry the greatest risk. Part of the Fund Managers role is to reduce the risk within the context of the fund’s overall risk profile, for example, by researching the companies they invest in and by spreading their investments across a number of different companies.

The nature and extent of risk varies between funds. Some people invest in a number of funds and it’s the total mix that explains the level of risk for that group of funds. Your financial adviser will normally help you make this assessment.



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What is volatility?

The term ‘volatility’ is often used when describing investments, but what does it mean?

Volatility is a measure of how much an investment has changed in value, both up and down, compared to its average or expected value. In this way investors can see by how much a fund’s value has changed and gain a view on the extent of the highs and lows.

This measure necessarily uses the past performance of the fund. It should always be remembered that past performance is not a perfect guide to the future as different conditions are very likely to apply going forward.

Volatility is often expressed as a number and is perhaps more useful when comparing funds. The higher the number the greater the difference between the highs and the lows. Funds with a greater difference between high and lows are generally considered more risky as there is less certainty on their value for the investor

The general factors that contribute to fund volatility and investment risk are explained below.

The amount invested in shares

Shares, sometimes called equities, represent part ownership of a company. Funds investing in shares will increase or decrease in value in line with the performance of the companies and markets in which they invest.

Shares offer the prospect of the highest returns over the longer term, but they also tend to be the most volatile over the shorter term. Share prices can move up and down quite sharply over short periods.

Investment funds may spread their investments over many different companies, and over a number of different markets and sectors. This tends to reduce reliance on one particular area and would, therefore, tend to reduce risk compared to those funds with less diversification.

Other funds may focus on specific areas or on a concentrated number of companies, aiming for even higher returns, which will tend to increase the risk of such funds. With less diversification these funds have more reliance on particular areas.

The amount invested in fixed interest

‘Fixed interest’ is the general name given to a range of investments that includes government bonds (also known as gilts) and corporate bonds. These bonds are essentially loans to the government or to the company concerned.

In return, the government or company pays a fixed amount of interest and agrees to repay the loan on a fixed date. Additionally, the bond can be bought and sold by other investors just like shares. Their value will depend in large part on the general level of longer term interest rates - as rates go up the value of bonds tend to fall, as rates go down the value of bonds tend to rise.



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If the markets think the government or company concerned may have some difficulty in paying the interest or repaying the loan when it is due, this will tend to reduce the value of their bonds.

Overall, bonds are usually less volatile than shares and are expected to produce lower but more stable returns than shares.

The amount invested in property or property shares

The value of a property fund is generally based on a valuer's estimate of the value of all the properties within the fund. When a property is sold the actual amount received will be reflected in the fund's overall value.

Property funds invest primarily in commercial properties – offices, retail premises, factories and so on and are also likely to hold some cash. During some periods a property fund may be unable or unwilling to buy properties and it will tend to hold a higher proportion of cash.

Conversely, at times commercial properties can become difficult to sell and a fund will want to avoid being forced into a quick sale. In these circumstances if there is not enough cash in the fund to pay those investors who wish to withdraw their money, there can be a delay (of several months) in cashing in an investment in a property fund.

Some funds don't buy actual property, but buy shares in companies in the property sector – such as developers, builders and commercial landlords. Here, while there is not the direct risk of being unable to sell assets quickly, falling property values and sentiment about the companies themselves will be reflected in the share price. Investing in property shares gives the same risks as other equity investments, as described above.

The amount held in overseas assets

Overseas investments are subject to fluctuations in the exchange rate between currencies, which have an impact on returns. For example, if a fund owns shares in a US company, those shares are priced in US Dollars. If the value of the US Dollar falls, then the value of the fund (in UK Pounds) will fall even if the dollar share price has not changed.

Investing overseas provides the opportunity to benefit from growth in businesses and markets all over the world. Even with increased globalisation, regional markets follow different economic cycles. Spreading your investment internationally can help offset a slump in one area against an upward trend in another.

The level of risk associated with overseas investments depends largely on the territories in which you invest. Many funds with overseas assets tend to focus on Europe, the US or Japan. These are all established markets with plenty of historical data and current research into the prospects for companies and sectors. This helps the fund manager in making investment decisions.

There are bigger risks to investing in emerging markets – those in less developed countries, with little history or detailed research. They may be less reliable in paying back debt and have a less stable economy.



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Emerging markets can be subject to significant economic or political instability and can lack the capacity to withstand major one-off disruptions. This can mean that share prices are highly volatile and can fluctuate wildly. And, because emerging markets don't have the volume of trade that the major world markets do, there are times when it can be difficult to sell shares at a good price.

The extent to which the fund invests in high yield assets

High yield bonds are those issued by companies, or governments, that don't have a credit rating – or whose credit rating is low.

Because these bond issuers are viewed as less credit worthy with a higher risk they may default on their loans, they have to offer a higher fixed rate of interest to borrow money. There is a straightforward relationship between the interest rate on offer, and the risk that goes with it: the higher the interest, the greater the risk that the borrower may not be able to make those interest payments or repay the loan when it becomes due.

The amount invested in smaller companies

The performance of smaller companies tends to be more volatile than those of larger companies. Relatively small events – winning or losing a contract, positive or negative press comment, changes in management personnel – will have faster and more direct impact on a small company and its share price.

Because there are fewer transactions in smaller companies' shares, the value of those shares can be more volatile. At times there may not be willing buyers so the share value could fall quite sharply.

The concentration in specific areas or sectors

Some funds invest in particular sectors, for example geographic region, company size or industry sector (for example, technology). Elsewhere in this guide we describe the particular risks associated with investing in overseas and smaller company funds.

When a fund is heavily exposed to a particular market sector or area, it is at greater risk from negative events in those investment environments. There is less opportunity to offset falls in one area with good performance in another.

What is ethical investment?

Ethical investment funds allow investors to apply some of their own principles, values and beliefs to their financial objectives.

Traditional ethical funds will not invest in companies involved in industries held to be environmentally or socially damaging – such as arms, alcohol, tobacco or perhaps oil production. By definition, this excludes some large and successful global companies.



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Socially responsible funds on the other hand adopt a broader approach to portfolio selection. They will still apply selection criteria, but will seek to engage with companies in controversial sectors, which have taken steps to improve environmental or social policies. This means they have access to a wider range of shares than ethical funds which can give greater diversification.

Crown ratings

Financial Express is an authority on performance measurement, providing data, advice and consultation to fund management professionals and financial advisers.

Financial Express also uses this knowledge and expertise to publish sector and constituent performance, Crown Ratings and the Adviser Fund Index.

Crown Ratings (shown on the Fund Factsheets) are compiled using three key measurements of a fund's performance – alpha, volatility and consistency. 'Alpha' measures the ability of the fund manager to actively manage the fund and generate out-performance. 'Consistency' measures how the fund performs over the long term – does the fund consistently perform well? 'Volatility' is defined earlier in this guide.

Financial Express Crown Rating 3 🏆🏆🏆

These represent the top 20% of funds in their sector. By definition they will have demonstrated a good record across the three performance criteria.

Financial Express Crown Rating 2 🏆🏆🏆

This rating goes to the next 30% of funds in the sector. Here the performance tends more towards the average for the sector. This could arise from a consistently average showing across the three criteria, or from elements of good performance which have been mitigated by a lower score in one of the other criteria.

Financial Express Crown Rating 1 🏆🏆🏆

This rating comprises the remainder of the funds in the sector. It does not necessarily indicate that there is nothing to recommend these funds. A meritable component of the rating could have been outweighed by negative criteria that would be tolerable within some clients' risk/reward profiles.

These ratings are, of course, intended to offer only a pointer as past performance is not a guide to the future.

Non-rated funds

To be eligible for rating, a fund must have the following characteristics:

- a 3 years track record
- in a sector of 10 or more funds
- and not belong to specialist or unclassified sector.

For more information on Crown Ratings and the methodology, see:
<http://www.trustnet.com/help>



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A level playing field for past performance comparisons

To allow investors to compare fund performance between different fund providers the Association of British Insurers (ABI) has introduced rules on the treatment of charges used in past performance figures. The rules are designed to ensure greater consistency in past performance reporting practices and involve presenting a primary fund series for all funds in the ABI sectors. The performance of the primary price series includes an allowance for the fund and product charges that apply to most investors.

You shouldn't use past performance as an indication of future performance. A more or less favourable economic period could have given better or worse returns. The same conditions are unlikely to apply again. We don't guarantee the value of an investment and its income, which can go down as well as up. You may get back less than you invested. Past performance shouldn't be the main or sole reason for making an investment decision.