focus

What is an asset class?

Anything that can be bought, sold or exchanged is an asset. An asset class is simply a category of asset.

In building up an investment portfolio it is important to understand the asset classes available to you. In this Focus we take a look at the four key building blocks of an investment portfolio, Cash, Fixed Interest, Property and Equities. In recent years access to investment types has widened, as a result we also introduce you to alternative asset classes that are now available to retail investors.

Key building block - Cash

Cash investments are designed to give relative security whilst earning some interest. This is generally held in the form of deposit accounts that pay regular interest and enables you to access your money easily.

Cash based investments have low risk and volatility and as such are seen as good for short term requirements and emergency funds. The security and level of access, is balanced by modest returns.

It is important to understand that cash is not a totally risk free investment. The rate of interest must exceed the rate of inflation to help you maintain the purchasing power of your money. There is also an 'opportunity risk' of not being invested into other types of investment which might provide a higher rate of return.

Key building block -Fixed Interest and Index Linked

When you purchase a fixed interest investment, you are lending your money to a government or company. In return, the borrower promises to pay interest at a set rate for a defined period. At the end of that period the borrower returns the money invested.

When stock markets are volatile, fixed interest and index linked investments offer stability while still providing income. Fluctuations in interest rates can affect the value of a bond. Generally speaking, when interest rates rise, bond prices fall and vice versa.

What are Government Bonds?

Government bonds are issued by governments across the world to raise money for public spending. They are traditionally considered the 'safest' type of bond as they are backed by government guarantees. However, it should be remembered that the level of risk depends on the stability of the country.

Bonds issued by the UK government are referred to as 'gilt edged securities' or 'gilts'. These are secure investments, with the interest and the repayment guaranteed by HM Treasury. With fixed interest securities, the investor is paid a fixed amount of interest regularly. Index-linked gilts pay regular interest payments, which rise and fall in line with the Retail Prices Index. Index-linked gilts therefore help provide protection against inflation.

The opinions expressed above are those held by The Roberts Partnership at the date of issue and are not a recommendation to buy or sell any investment. Past performance is not a guide to future performance. Investments can go down as well as up. The Roberts Partnership is authorised and regulated by the Financial Services Authority.

What are Corporate Bonds?

Corporate bonds are issued by companies usually to help finance or expand operations. These are effectively loans from investors to the company in question. Generally they offer higher returns than government bonds, but also carry a higher level of risk.

They are rated according to how likely it is that the income payments and capital return will be met by the company concerned. The more financially secure a company the lower the interest rate it will need to offer to attract investors. A less secure company may, however, need to offer higher interest to compensate for the greater risk of it defaulting on payments.

To give investors an idea of this risk, most corporate bonds receive ratings from independent agencies such as Standard & Poor’s or Moody’s. These ratings reflect a company’s ability to meet liabilities and therefore influences the rate of interest on offer.

These ratings divide the market into two key sections - investment grade and high yield. Investment grade bonds are considered the lowest risk, while high yield bonds are more likely to default and therefore tend to offer higher interest rates to tempt investors.

At the very bottom are junk bonds where rates appear very attractive but the risk of default (i.e. losing some or even all of your investment) is significant.

Key building block - Commercial Property

Property has proved a very popular investment choice as the benefits have become increasingly understood. Despite recent falls in valuations, the diversification benefits and characteristics it offers remain attractive for an investor looking to widen their portfolio.

Commercial property in particular has garnered a lot of interest. It offers both an income stream and the potential for capital growth. In principle, the rental payments from tenants act like the interest payments from bonds and any rent rise not only helps that income increase but can also support the property's value.

As with all investments it is best not to be too reliant on one asset. An investor should therefore look to have a portfolio of properties so as to balance the risk of having a property vacant for any period of time.

Both residential and commercial property carry the same sort of risks - that tenants may not be found and so income may be zero and also the value may fall or the property may take a very long time to sell. However, when tenants are found, commercial leases tend to be longer, which offers greater stability of income. Commercial tenants are also subject to close financial screening, so are considered less likely to default.

Given the cost of property it is often not possible for an individual investor to be able to acquire attractive properties or sufficient properties to create a balanced portfolio. As a consequence, investment into commercial property should be through the use of collective funds which invest into larger scale office, industrial and retail properties throughout the UK or across the world.

Commercial property tends to be negatively correlated with equities and bonds. This means that property can still increase in value when equity and bond markets are falling (and vice versa). It should be noted that in certain extreme market conditions, such as those occurring in the 2008-09 “credit crunch”, its correlation to equities and bonds will increase.

Key building block - Equities

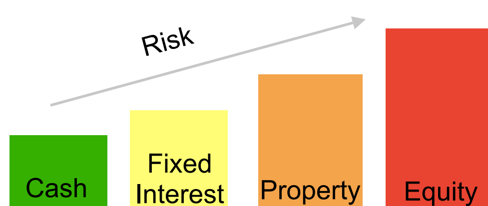
These represent a direct investment in the equity of a company listed on the UK or other world Stock Exchanges.

The investment is speculative since its value is dependent upon many factors and can rise or fall by significant amounts. The value of the investment can be influenced by general market factors which are not related to the performance of the company in question. Therefore buying a high performing company does not reduce the risk of being invested in a volatile stock market.

Over the longer term, equities have generally produced higher returns when compared to other asset classes. Returns from equities remain volatile, not just on a daily basis but also year-by-year. The value of shares and any dividend income, can go down as well as up and you may get back less than you originally invested.

There are, however, a number of ways to minimise these risks. First, the stock market should only be considered as a long-term investment - usually at least five years. Also, rather than buying just one or two companies, consider a pooled investment, where your money is combined with that of many other investors. The advantage here is that a smaller amount of money can get you access to a much wider selection of companies.

The choice of such funds is very wide. Some simply track a stock market index while others employ a professional fund manager to take active decisions over companies. Some target income, others growth and some even specialise in specific regions or sectors. You do not have to put all your nest egg in one basket.



Each of the four main asset classes have a different level of risk. This ranges from the security of Cash and Gilts through to the volatility of Equities.

Alternative assets - Commodities

With rising energy prices and geo-political pressures, commodities such as oil and gas continue to be headline news. However, energy is just one commodity sub-sector. Commodities encompass many other materials, such as livestock and agricultural products, as well as precious and industrial metals.

In recent years, commodity prices have been strong, boosted by demand from global powerhouses such as India and China who need commodities to build the infrastructure necessary to support their growth. However, those same commodities have also been blamed for creating inflation (when demand exceeds supply this can create inflationary pressures as prices are driven up by those most desperate to buy) and while supply remains finite, this could continue to be a problem.

Investors are therefore excited at the potential this sector offers and also by the low correlation they have traditionally demonstrated with other asset classes. However most investors would not want to take delivery of a tonne of copper. The easiest way to invest is therefore via pooled products accessing a range of commodities, or through the shares of companies operating in that sector. But don't overlook the possibility you may already own some. Oil and mining stocks are very well represented in a FTSE 100 index fund as they sit among the largest companies in the UK.

T. 0161 835 2266
W. www.robpar.co.uk

Alternative assets - Hedge Funds

Hedge funds give the fund manager as much flexibility as possible. They can take high risk positions where they have strong conviction regarding the outcome. This involves identifying investments that they believe are either too cheap, or too expensive.

Hedge funds can buy an asset in the expectation that its price will rise over the long term. They can also take ‘short’ positions where they have a negative view. That is, they can sell a stock they do not own, in the expectation the price will fall and they will be able to buy it later at a lower price.

The term ‘hedge fund’ covers a wide range of investment strategies, from the lower risk, aiming to preserve capital, through to the very high risk, perhaps even using large amounts of debt – gearing – to try and boost returns.

They usually have high minimum investment levels and lack the transparency of traditional funds. Indeed, many will not reveal how they make their money in case it moves the market and jeopardises their returns. They are also generally unregulated and most are based offshore.

For example, a hedge fund manager might aim to produce 'absolute' returns of, say, 10% per year, regardless of whether equity markets go up or down. They might aim to do this by taking ‘short’ positions to make money from a stock if its price falls, as well as holding stocks in a traditional way to make money if its price rises.

Other more sophisticated 'macro' techniques might aim to make money from currencies or interest rates. And some hedge fund managers will borrow to try and magnify their returns - and it is these highly-geared funds that have been the source of most of the sector's well-publicised problems. Because of all these different techniques, hedge funds are only suitable for the most sophisticated or experienced investors who can understand the processes and therefore appreciate the full extent of the risks involved.

Alternative assets - Private Equity

Private equity has only recently become accessible by retail investors.

As a rule, a private equity firm combines its clients’ money with bank loans to buy the entire equity capital of a target company. The private equity firm will then work with a management team to effect changes in the business. This involves cutting costs and selling off non-core interests, in order to increase its value with a view to selling at a profit over a two to five year period.

Alternative assets - Structured Products

Structured products aim to reduce the risk associated with, but still benefit from the performance of, a particular asset class. They generally consist of two components – an element of capital protection and/or an ‘at-risk’ element, which offers the performance potential. In addition, they are also usually linked to an index.

The fund manager may buy an option that tracks the FTSE 100 share index. They can then use further derivatives to manage the risk of this holding. For example, the fund manager might arrange to give up some of any increase in the FTSE 100 in exchange for insurance against a fall. The amount you get back may be less than the original investment. Growth is not guaranteed, as this depends on market performance.

It is important that your investment portfolio is diversified both between and within asset classes.