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FACTSHEET

Diversification, diversification, diversification

Portfolio building requires different characteristics to evaluate

There are many ways to invest and different types of investments. But when looking to build an appropriate diversified portfolio, investors have a number of different characteristics to evaluate. For example, is the investment designed to provide growth or income? Is it domestic or international? Does it have a maturity? Another consideration is whether the investment is actively or passively managed.

Sometimes, that simple, fundamental choice can make a difference in portfolio performance. During a particular market climate, one of these two methods may be widely praised, while the other is derided and dismissed. In truth, both approaches have merit, and all investors should understand their principles.

ECONOMIC AND MARKET CONDITIONS

Active fund managers select individual stocks. Stock selections decisions in active funds are based on factors such as economic and market conditions as well as company-specific issues, (for example, the profitability of a company and the strength of its management). Alternatively, passive or 'index-tracking' funds aim to replicate a specific market index.

An active fund is managed with the aim of generating returns greater than the relevant markets, as measured by an index. Active fund managers base their stock buying and selling decisions on several factors, including market conditions, political climate, state of the economy, and company-specific factors that include profitability and market share.

INDUSTRY SECTOR OR COMPANY SIZE

Depending on the fund's objective, an active fund manager may have little or no constraint on their investment choice. Where this is the case, they can select what they consider the most promising opportunities, regardless of industry sector or company size. They aim to maximise gains in rising markets and limit the effects when markets are falling.

Actively managed funds have the potential to outperform and, conversely, under perform compared to a market index. They have the flexibility to invest where the investment manager believes there are the best market opportunities. They have the ability to minimise losses in a falling market by investing in shares outside the index, and typically have higher annual management charges than for passive funds, in return for the investment managers' potential to outperform the market.

TRYING TO MATCH THE INDEX

A passive, or index-tracking, fund is managed with the aim of replicating the performance of a specific index. To track the FTSE 100, for example, an investment manager will aim to invest in the same shares, in the same proportions, as this index. Passive fund managers won't make any 'active' decisions, as they're only trying to match the index. The fund will generally rise and fall with the index.

They perform well when markets rise and poorly when they fall, but funds can be less diversified than active funds, as the relevant index may be dominated by just a few large companies. A change in the investment manager should have no impact on its performance. In addition, passive funds generally offer lower annual management charges and typically have a lower turnover of shares that can mean lower transaction costs apply.

RISK IS INHERENT WITH ANY INVESTMENT

It's important to remember that a degree of risk is inherent with any investment, and the potential for greater returns comes with a higher degree of investment risk. While a passive fund is considered to have less investment risk associated with it than an actively managed fund, there are still risks (such as stock market risk) involved.

As with most investment decisions, there is no right or wrong selection. The choice is down to the individual investor, their investment objectives, attitude to risk, and the economic and market environment at the time. It is generally accepted that asset allocation has the biggest impact on the variability of returns within an investment portfolio. ■

LOOKING TO REVIEW YOUR INVESTMENT OPTIONS OR PORTFOLIO?

There are many ways to invest and different types of investments. If you are unsure of what is right for you, or are interested in adding further assets to your portfolio and would like to review your options or portfolio, please contact us.