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## Investment Philosophy

### Introduction

Investing is an extremely complex business and the investment world abounds with a multitude of varying philosophies, concepts and structures. However, myths abound, at Collins Ward we ask you to take a look from a fresh perspective. The following is a quote from John F Kennedy's 1962 Yale address:

**“For the great enemy of truth is very often not the lie – deliberate, contrived and dishonest – but the myth – persistent, persuasive, and unrealistic. Too often we hold fast to the clichés of our forebears. We subject all facts to a prefabricated set of interpretations. We enjoy the comfort of opinion without the discomfort of thought.”**

One of the “persistent, persuasive, and unrealistic” myths that should be addressed is that professional investment managers, as a group, can somehow ‘beat’ the market. Today’s capital markets are far removed from the cosy world of stockbroking and investment management of yesteryear, and are dominated by institutions staffed by intelligent, highly motivated and highly rewarded professionals all striving to identify mispriced securities, and thus beat the market. But amazingly, approximately two-thirds of investment managers have under-performed the market over the long-term. In his seminal 1975 paper entitled “Winning the loser’s game”\*, Charles Ellis described how investing had moved from being a winner’s game to a loser’s game, where rather than the outcome being determined by the correct actions of the winner, it is determined by the mistakes made by the loser. In trying to do better than the market, investors lay themselves open to making many mistakes including: holding the wrong stocks, being in the wrong asset class at the wrong time, excessive portfolio turnover and chasing ‘flavour of the month’ investment themes.

At Collins Ward we help you to understand the nature and realities of today’s institutionally dominated investment markets, and in JFK’s words, move you to a “...new, difficult, but essential confrontation with reality.”

- We put the achievement of your goals and objectives at the very heart of our investment planning, optimally structuring your portfolio for your time horizon and the amount of risk that you are willing to accept in the achievement of your objectives.
- Our clearly defined investment philosophy and robust investment proposition are built using Nobel Prize winning economic theories, thorough empirical research, asset allocation modelling and trading efficiency all tailored with common sense to modern capital markets.
- We help you to maintain a rational long-term focus through market highs and lows when emotions are strongest, and when remaining true to a sound investment policy is hardest.

\*Please look in the resources section of the website for a copy of this paper.

### Key concepts

#### ***Capital markets work***

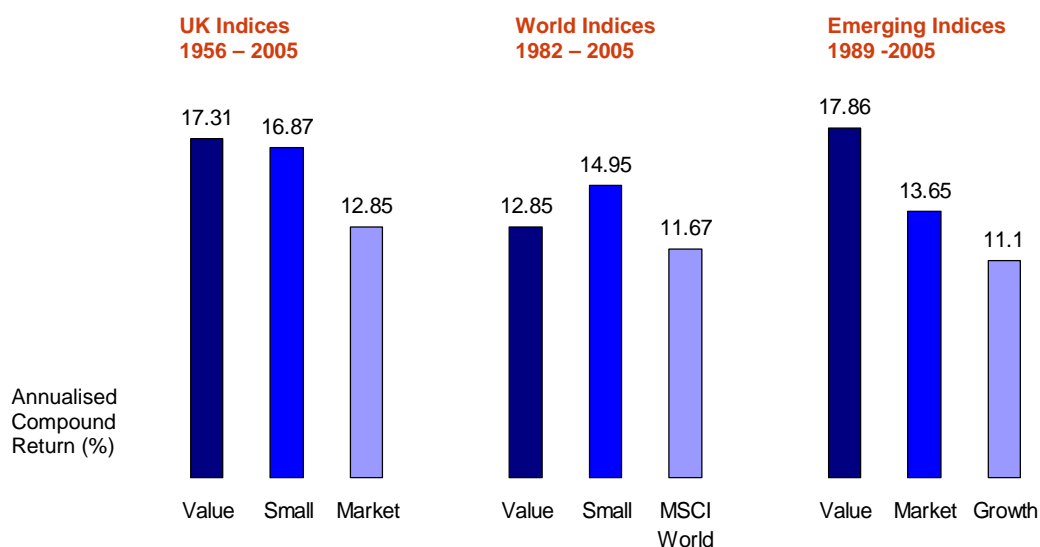
Markets throughout the world have a long history of rewarding investors for the capital they supply. Companies compete with one another for investment capital, and millions of investors compete with one another to find the most attractive returns. This competition tends to drive prices to ‘fair’ value, making it difficult for investors to achieve greater returns without bearing greater risk. Markets don’t have to be right to be efficient. If markets systematically misprice stocks then it would surely be easy for skilled investors to reap the rewards? However, virtually every economist who has studied this question would disagree and can find no significant link between outperforming the market and continuing to do so with any persistency, other than that expected through chance alone; in simple terms, the very presence of so many skilled investors creates an environment where stock prices are the result of the consensus view of a stock’s value at that time. Capitalist economies thrive – not because markets fail but because they succeed.

#### ***Take risks worth taking***

Academic and practical evidence points to an undeniable conclusion; returns are related to risk. Gains are rarely achieved without taking some chance, but not all risk-taking is rewarded. Developments in financial

academics over the past 50 years have bought us a powerful understanding of the risks that are rewarded and those that are not, and can be summarised as follows:

- Stocks are riskier than bonds and have greater long-term returns. Bonds generally offer both a regular income and a fixed redemption date, whereas stocks offer no fixed entitlements.
- Relative performance among stocks is driven by two other dimensions: 'small' and 'value' company stocks outperform 'large' and 'growth' company stocks, as investors demand a price discount to reflect the greater underlying risk in small and value company stocks. The discounted prices provide greater upside as compensation for bearing the increased risk. Value and small capitalisation stocks therefore have a higher cost of capital, as they must pay higher rates of interest on their debt and offer a higher return to attract equity investors.



In British pounds. UK Value data provided by the London Business School and simulated by Dimensional from StyleResearch data. UK Small: 1956-June 1981 provided by London Business School and ABN AMRO: July 1981-present simulated by Dimensional from StyleResearch securities data. UK Market is the FTSE All-Share Index, published with the permission of FTSE. Non-UK Value is the MSCI World ex UK Index, net dividends. Non-UK Small: 50% EMEA small companies simulated by Dimensional from StyleResearch securities data (25% continental Europe, 12.5% Asia Pacific ex Japan, and 12.5% Japan) and 50% Fama/French US Small Cap Index. MSCI indices are net dividends; data copyright MSCI 2006, all rights reserved. Emerging markets index data simulated by Fama/French from countries in the IFC Investable Universe. Simulations are free-float weighted both within each country and across all countries. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Compound returns have an assumed rate of return, are hypothetical, and are not representative of any specific type of investment.

### Size and value matter

Small cap and value effects are strong around the world. Smaller and lower-priced value stocks have higher risk and greater expected returns than larger and higher-priced growth stocks.

### **Structure is the strategy – Diversification is imperative**

Successful investing means not only capturing risks that generate expected return but reducing risks that do not. Unrewarded and therefore avoidable risks include: holding too few securities, betting on countries or specific sectors of the market and following market timing predictions. Diversification is the antidote to all these avoidable risks, and in simple terms is no more than that old adage 'don't put all your eggs in one basket'. It negates the random fluctuations of individual stocks and positions your portfolio to capture the returns of broad economic forces.

No investor wishes to see the value of their portfolio fluctuate wildly, and the unique power of diversification is to reduce this portfolio value fluctuation without reducing the expected long-term return. In fact, diversification is so powerful that it is often described as the only 'free lunch' in the investment world, yet it is still common for investors to hold portfolios which are not truly diversified on an asset class basis, geographically or across sectors of the market.

### **Asset Allocation is paramount**

Asset allocation is the process of deciding how much of your portfolio to invest in each of the main investment types, or asset classes - cash, bonds, equities and alternative asset classes such as property. You will often hear investment companies and advisers stating that over ninety percent of portfolio performance is determined by asset allocation, with the remaining ten percent attributable to stock selection and market timing. This notion

stems from the 1980s and has been hotly contested by practitioners and academics ever since. However, no sane investor can deny that stock selection and market timing cannot be important determinants of return, it's just that you cannot forecast or control the results of timing and selection. In simple terms, since you cannot successfully time the market or select individual stocks, asset allocation should be the major focus of your investment strategy because it is the only factor affecting your investment risk and return that you have complete control over.

Successful asset allocation exemplifies the importance of combining art and science in portfolio construction. Mechanistic computer programmes can produce naïve and sometimes disastrous conclusions, whereas intuitive or spontaneous decisions lack rigour and are unlikely to produce good long-term results. Marrying seasoned judgement with the science of economic analysis creates a powerful approach to allocating your assets.

### ***Minimise unnecessary costs***

Professional investment management comes at a price, but there are certain costs which can and should be minimised. Costs are an immediate performance drag on a portfolio and eat directly into the available capital market risk premium. Disclosed costs are only a small part of the issue; the investment industry is notorious for obfuscation, and an annual management fee of 1.5% can easily lead to total annual expenses of 3% or more for retail investors. Costs for investing in specialist sectors, such as small companies stocks, venture capital or emerging markets, are even higher and can even negate any available risk premium for these sectors.

The authoritative 2002 study 'Triumph of the Optimists' stated that the historical equity risk premium (the additional return generated by equities over a risk-free bond return) was 6.0% in the UK throughout the 20<sup>th</sup> century. If this premium were to continue in the future, and with a 3% per annum expense ratio, then over half of the return available from holding equities would be sacrificed to your investment manager – not an appealing prospect.

## **How we structure portfolios**

### ***Risk assessment***

We take considerable time to understand your own risk tolerance. This process starts with clients undergoing a detailed psychometric risk analysis, developed by industry leaders Finametrica ([www.risk-profiling.com](http://www.risk-profiling.com)). This is followed by a full and frank discussion of the parameters of risk and return, and what you can expect from an investment portfolio in the real world of investing. This includes quantitative analysis of the expected returns and potential short-term losses that portfolios of varying risk offer.

### ***Multi asset class portfolios***

By utilising both traditional and non-traditional asset classes we can not only provide increased diversification over and above that inherent to traditional stock and bond portfolios, but also improve expected returns. We build portfolios with collective funds that are structured to provide the capital market return from a specific sector. We access the broad returns available from world capital markets but engineer portfolios to garner the additional returns available from those sectors of the market that offer higher returns, e.g. 'value' and 'small' capitalisation stocks.

### ***Institutional Collective funds***

Collective funds are the most effective holding structure for private investors due to the diversification, cost and tax minimisation benefits. Newton Investment Management, who manage monies for private clients on a segregated basis (portfolios of individual securities) and a collective basis, estimate that the cost and tax savings for their collective portfolios are approximately 1% per annum – a significant saving over the medium to long-term. Collective funds allow you to hold thousands of securities from around the world, thus benefiting from real diversification that only ultra-high-net-worth private investors can replicate.

Collective funds, unlike segregated portfolios, are not liable to capital gains tax on any security sales - a very significant benefit which allows fund managers to reposition their portfolio allocations without incurring the tax liabilities which a segregated portfolio would incur.

We only utilise institutional collective funds which benefit from exceptionally low costs compared to their retail counterparts. They have no initial charges and annual management fees average 0.47%. Most retail funds charge between 3 and 5% initially and have average annual management fees of 1.62%\*. Institutional funds

have high minimum investment levels, but due to our size and scale we can provide access to these funds, which would otherwise be out of reach to the majority of private clients.

\*Fitzrovia 2005 annual charges report

### **Passive investment – not index tracking**

We do not use index funds which aim to deliver a return linked to a specific stock market index, as these funds naïvely track the performance of an arbitrary index, and are forced to trade in line with index movements. The passive funds we utilise are structured to garner the specific returns available from an asset class, and retain the flexibility to make trading decisions that add value. This results in low portfolio turnover – often around 10% per annum – against the industry average of 92%, thus keeping trading costs to a real minimum. A full replication index fund can have portfolio turnover of some 30% per annum, meaning too much investor money is wasted on trading costs.

The cost of a round trade, i.e. selling a security and buying another to replace it, has been estimated at 2% for a large capitalisation stock, and a portfolio turnover rate of 92% would result in annual trading costs of 92% x 2% or 1.84% per annum, which would be in addition to the stated management fees and expenses.

### **Reviews, reporting and rebalancing**

Under our investment management service, we monitor the performance and ongoing suitability of your portfolio so that you don't have to. We implement any rebalancing when necessary to ensure your portfolio's asset allocation remains in line with our recommendations. Rebalancing is a sound policy to promote a natural 'buy low – sell high' approach throughout all market conditions, as winning investments are trimmed and losing investments are topped up. This process provides much needed discipline, and ensures that you are not exposed to the dangers of style drift and the consequent increase in risk that afflicts completely passive portfolios or segregated portfolios that are hindered by capital gains tax concerns. At the outset we agree the reporting frequency that you require and the benchmarks that your portfolio will be judged against, all of which will be coordinated with any recommendations within your updated financial plan.

### **Ongoing research**

We have invested considerable time and finance into developing our wealth management philosophy and proposition. Continued research is at the heart of the Collins Ward approach, as our investment philosophy evolves with ongoing developments in modern portfolio design. We remain committed to building portfolios that provide our clients with the peace of mind that they have a portfolio efficiently structured for the successful attainment of their personal goals and objectives.

### **Our lead fund managers – Dimensional Fund Advisors**



#### **Idea growth engine**

Clients benefit when research and experience combine to solve new investment challenges. As often as a research innovation generates a new technology, a client need or investment problem drives a new solution

Dimensional Fund Advisors (DFA) are experts in passive fund structuring and implementation. Their founders implemented the first index fund strategy in 1970 and they remain at the forefront of the asset management industry. They have unique relationships with leading financial economists and by acting as a conduit between scientists and practising investors, have pioneered both strategies and consulting approaches now taken for granted in the industry. Their funds ensure clients can tailor their portfolios with a range of highly engineered vehicles that will continue to evolve with developments in science.

An excellent example of their individual approach is that they do not structure funds on a commercial index basis, rather their funds aim to capture the return offered by the sector targeted, i.e. small company stocks. This strategy ensures they do not have to slavishly follow an arbitrary index, but can capture the capital market rate of return for the relevant asset class, without the costs associated with matching an index. Trading stocks is expensive, and Dimensional are world renowned for their trading expertise to reduce or even reverse the costs borne by traditional managers – savings which accrue directly to an investors bottom line.

By being patient when others are pushing to transact and by being thrifty when others pay a premium, Dimensional provide real added value. In our opinion no other asset manager can currently match their proposition, but we continue to research the market and look forward to the day when other firms can provide competitive funds. We have no financial relationship with DFA and we utilise investments from across the marketplace.

## Summary

**“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”**

Warren Buffett – from the introduction to Benjamin Graham’s ‘The Intelligent Investor’

Collins Ward provides both the framework and the cool hand of reason to keep you from making emotional decisions that could have disastrous consequences for your wealth. If you would like to gain a fresh perspective on how to structure your investment portfolio efficiently, and to prevent mistakes which could seriously hamper your chances of meeting your financial and lifestyle goals, please contact our Managing Director, Christian Ward on 020 7073 2956 or via email at [christian.ward@collinsward.com](mailto:christian.ward@collinsward.com).

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