

## Making investments clearer

### A level playing field for past performance comparisons

The Association of British Insurers (ABI) has introduced rules on the treatment of charges to ensure greater consistency in past performance reporting practices. For all funds in ABI sectors, the primary price series reflects the fund charge that applies to most customers. We are required to supply a primary price series as defined below:

- For funds still open to new business, the primary price series is defined as the fund charge that applies to the greatest volume of new life (investment bonds) and pension (personal pensions or group personal pension) plans.
- For closed funds, the primary price series is defined as the fund charge that applies to the greatest number of remaining planholders. This allows customers in closed funds to have easy access to comparative performance data.

Providers of gross funds are required to incorporate an 'indicative net' fund charge into the primary price series in order that they can be fairly compared with net funds. The indicative net fund charge is equivalent to the charge that applies to most new customers investing in the fund as a result of unit cancellation. The indicative net is incorporated into the price series for all years where the primary price series has been gross.

Where the current primary price series has a short history, it can be linked to the performance data for the previous primary for the same fund for the years before the current primary series started. This is known as 'chain-linking' and provides the fund with performance data which incorporates the typical charge that applied in all periods.

For more information, please see:

[http://www.abi.org.uk/Display/default.asp?Menu\\_ID=1140&Menu\\_All=1,946,1140&Child\\_ID=460](http://www.abi.org.uk/Display/default.asp?Menu_ID=1140&Menu_All=1,946,1140&Child_ID=460)

### What is volatility?

In general, high volatility means high unpredictability, bringing with it greater risk. When used about investment funds, volatility can be explained as:

**'A measure of how much a fund's price varies over time, from its average growth rate'.**

High volatility means that the differences – up or down – between actual and average growth rates can be both sharp and frequent. The greater the volatility, the greater the risk of buying into a fund at an unusually high price, and having to sell at an unusually low one.

This is a vital consideration when you are assessing how risky a particular fund is.

An example may help:

Both Fund A and Fund B have produced an average of 10% growth over a period. During that time, Fund A's growth has never been 5% higher, or 5% lower, than the average. During the same period Fund B has on occasion produced a return of 25%, but has also fallen to 5% below its original value.

In this example – which is for indicative purposes only, and does not represent actual performance of any real fund – Fund A is a lower risk investment to get the average return. Fund B has the greater potential for above average returns and hence volatility, but it is also more likely to lose some of its value.

## **What is your investment risk profile?**

### **Your attitude to risk will largely determine the decisions you make about your investments.**

In some respects, your attitude to investment risk will reflect your individual personality and your view of the world. How do you feel about setting up your own business instead of having a steady job? Do you prefer to wait until you have the money when buying something or are you happy to take a loan?

When it comes to your investments, some of these instincts will inevitably come into play. However, your investment goals – what you want to achieve with your money, and when – will be far more influential.

Zurich has developed five 'risk profiles', from 'Cautious' to 'Adventurous', designed to help investors match their investment fund choices with the level of risk they are prepared to accept.

The table below describes these, and summarises the main features of the funds that fit each profile. Identifying which of these matches your own approach to money is an essential first step in building your investment portfolio.

It is quite likely that your risk profile will evolve over time, as your personal circumstances, goals and time horizons change. By keeping your investments under review, with an adviser if you have one, you will make sure your investment choices keep pace with these changes.

<b>Risk profile</b>	<b>Description</b>	<b>Fund features</b>
<b>CAUTIOUS</b>	<p>You are prepared to take a lower risk with your investment and so wish to avoid the risks usually associated with investing all your money in company shares. You are looking for an investment that is expected to be more stable and fluctuate in value far less than company shares and so is likely to involve a very high proportion of fixed interest assets. As a consequence, you accept that the investment return is likely to be much lower. You appreciate that over some periods of time the value of your investment can fall and you may get back less than you invest.</p>	<p>This fund invests in assets which tend to produce more stable returns. Over the longer term these assets should give lower but steady growth, with some fluctuation in value. [for funds deemed short-term]</p> <p>Unless held as part of a bespoke portfolio this fund is more suited for a short-term holding. As such the return could be less than a building society or bank account.</p>
<b>MODERATELY CAUTIOUS</b>	<p>You are prepared to take moderate risks with your investment but wish to avoid the risks usually associated with investing all your money in company shares. You are looking for an investment that is expected to fluctuate in value less than company shares and so which is likely to involve a significant proportion of fixed interest assets. As a consequence, you accept that the investment return is likely to be lower. You appreciate that over some periods of time the value of your investment can fall and you may get back less than you invest.</p>	<p>This fund invests in assets which tend to produce moderate and stable returns. Over the longer term these assets should generate growth, with some fluctuation in value.</p>

<p><b>BALANCED</b></p>	<p>You are prepared to take a measured risk with your investment in return for the prospect of good longer term investment performance. While investing in company shares and property often gives the best potential for growth, you wish to limit the amount you invest in these areas. You are looking for an investment with the potential to produce good returns above inflation but with less fluctuation in value compared to company shares alone. You appreciate that over some periods of time the value of your investment will fall and you may get back less than you invest.</p>	<p>This fund invests in assets which tend to produce a good level of return. Over the longer term these assets should generate real growth. There will be fluctuations in value, particularly over shorter periods.</p>
<p><b>MODERATELY ADVENTUROUS</b></p>	<p>You are prepared to take more risks with your investment in return for the prospect of better longer term investment performance. You are looking for an investment that has the potential to produce above average longer term returns, which is likely to involve a high proportion of worldwide company shares. You appreciate that over some periods of time there can be sharp falls, as well as rises, in the value of your investment and you may get back less than you invest.</p>	<p>This fund invests in assets which tend to produce a higher level of return but with more risk. Over the longer term these assets should generate greater growth. There will be more fluctuation in value, which at times may be quite sharp.</p>
<p><b>ADVENTUROUS</b></p>	<p>You are prepared to take greater risks with your investment in return for the prospect of the highest longer term investment performance. You are looking for an investment that has the potential to produce superior longer term returns, which is likely to mean investing fully in worldwide company shares. You appreciate that over some periods of time there can be significant falls, as well as rises, in the value of your investment and you may get back less than you invest.</p>	<p>This fund invests in assets which tend to produce the highest level of return but with higher risk. Over the longer term these assets should generate superior growth. There will be greater fluctuations in value, which at times may be dramatic.</p>

## Some fund types explained

### Managed funds

A managed fund invests in a range of different asset classes with the aim of achieving growth and/or income. The fund manager may adjust the relative proportions of the different asset classes, within certain limits, to give the best chance of meeting the fund's objectives.

By investing in a range of asset classes, managed funds differ fundamentally from cash, bond, property or equity funds, which invest predominantly in one asset class.

### Protected funds

These funds aim to give investors an element of protection from the effects that market falls can have on investment funds. Protected funds may have a protected price, which aims not to fall, whatever happens to stock markets.

Fund managers use different methods to achieve this. Continuous unit price protection aims to ensure that the price won't fall below 80% of the highest ever selling price. Price protection on quarterly dates aims to lock-in some of the growth at 3-monthly intervals, and to limit any falls in price from one quarter to the next.

### Asset classes explained

The four main asset classes are:

- cash
- bonds (or fixed interest)
- property
- equities (or shares).

They each have their own characteristics, and carry varying degrees of volatility and growth potential. These are outlined below:

#### Cash

Cash is the most secure of assets. Unless the financial institution holding your money collapses, you will always get your money back (less any charges). Inflation is the only factor that will have a negative impact on its value. If inflation is higher than interest rates, the value of your cash will fall in real terms.

When you invest in a **cash fund**, you pool your money with that of other investors. This can create economies of scale, enabling the fund manager to negotiate better interest rates. It is also relatively easy to get hold of your cash investment if you want to move it into other assets, as your investment goals change.

While cash is safe, over the medium to long-term it will tend to deliver lower returns than the other asset classes.

## **Bonds**

Bonds are essentially IOUs, issued when you make a loan to public or private sector organisations. In return, the bond issuer will pay you regular interest, usually at a rate that is fixed when the bond is issued. For this reason, these are known as 'fixed interest' investments.

At the end of the bond's term, the issuer should pay back the original loan. Bonds are traded on the stock market, where their value can go up and down. These fluctuations are primarily driven by the interest rate the bond offers.

Types of bonds:

- **Bond funds**  
Bond funds are less secure than cash, but safer than equities.
- **Government bonds**  
Government bonds are issued by governments of the UK and other countries. Also known as gilts, UK Government bonds are among the safest of investments, because it's unlikely the government will fail to make its payments. This may not be the case with bonds issued by the governments of some other countries, with weaker or less stable economies.
- **Corporate bonds**  
Corporate bonds are issued by private companies who want to raise money. They offer investors the opportunity to benefit from the success of businesses in the UK and overseas. However, the risk that a company will fail to make its payments is greater than the risk the UK government will. For this reason, corporate bonds normally offer higher interest than gilts.

Generally, the bonds issued by companies that are less established and financially secure will offer a higher interest rate. They also carry a greater risk. Specialist independent companies – such as Standard and Poor's and Moody's – provide objective credit ratings for most bonds.

Over the long term, corporate bonds have historically given lower returns than equities. However, companies must pay interest due to bondholders before they can pay any dividends to shareholders.

## **Property**

If you own your own home, you're already invested in the property market, and subject to its ups and downs. Through **property funds**, you can also invest in commercial buildings, such as factories, shops and offices. The funds may actually own the properties themselves, or buy shares in companies that rent, manage or develop property. The returns on these funds are determined by the market value of the properties they invest in, and any rental income.

Recent years have seen consistent, even spectacular, growth in property values. However, when property values fall – because of increasing interest rates or a slowdown in the economy – they can do so rapidly and steeply.

Because properties can sometimes take a long time to sell, you may not be able to cash in a property investment at the time you want to. Conversely, if property is scarce, the property fund may have to keep a relatively high proportion of cash, which could depress its growth.

## **Equities**

Equities, or shares, represent part ownership of a company. **Equity funds**, which pool your money with that of many other investors, increase or decrease in line with the performance of the companies and markets they invest in.

Of all the asset types, equities offer the prospect of the highest returns over the long term. Historically, stock market performance has significantly exceeded both returns from cash investments, and the rate of inflation.

Through equity funds, you can invest not only in **UK** companies, but also internationally. There are funds that focus on each of the major established markets – **Europe**, the **United States** and **Japan** – and **global** funds that spread their investments across more than one region.

The financial markets in less developed countries, with short investment histories, are known as **emerging markets**. These can be subject to significant economic and political instability, which makes investing in them relatively high risk. Share prices in emerging markets can fluctuate violently.

Equity returns are subject not only to the performance of individual companies, but entire market sectors and economies. World events – war, terrorism, civil unrest – can also have a direct impact on stock markets. With any overseas funds, currency exchange rate fluctuations can affect the value of investments.

If you enter the equity market at the wrong time, you could suffer substantial losses in the short term. So it's important to view equity funds as long-term investments.

*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 tax conditions are unlikely to apply again. We don't guarantee the value of an investment, and any 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.*

## **Risk factors explained**

All funds carry some risk, and you should consider these before making any investment decision.

The nature and extent of the risk – and the factors which contribute to it – vary according to the objectives and structure of the fund.

In this section we explain what these factors are.

### **The amount held in overseas assets**

All overseas investments are subject to fluctuations in the exchange rates between currencies, which have an impact on returns.

Investing overseas provides the opportunity to benefit from growth in businesses and markets all over the world. Even with increased globalisation, regional markets have 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. The majority of overseas funds (those that invest 80% or more in a specified geographical area) 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.

There are bigger risks to investing in emerging markets – those in less developed countries, with little history or detailed research. They often have poor records in paying back debt, and are relatively new to economic liberalisation.

These markets can be subject to significant economic and/or political instability, and can lack the substance to withstand major one-off disruptions from, for example, environmental catastrophe. 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, it can be difficult to sell shares when you want to.

### **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 lower than that required for 'investment grade' securities.

Because these bond issuers are less credit worthy, they have to offer a higher level of potential return (or yield) in order to borrow money. There is a straightforward relationship between the interest rate on offer, and the risk that goes with it: the higher the potential yield, the greater the risk that you could lose some or all of your money.

## **The concentration in specific areas or sectors**

The main criteria for sector funds are geography and company size. 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 clearly at risk from negative events in those investment environments. Managed funds can mitigate some of this risk by spreading investments across a range of equity markets and asset classes.

## **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 any companies involved in industries held to be environmentally or socially damaging – such as arms, alcohol, tobacco or even oil production. By definition, this excludes some of the biggest and most successful global companies, with strong records of gains over time.

Socially responsible funds on the other hand adopt a more positive 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 stocks, which tends to make them less risky.

## **The amount invested in property or property shares**

The value of property is generally a matter of a valuer's opinion, rather than fact.

Property funds invest primarily in commercial properties – offices, retail premises, factories and so on. During periods of sustained growth in property prices – such as we have experienced in recent years in the UK – there is a lot of competition for these properties when they come on the market. If a property fund is unable to secure properties in the face of these competitive pressures, it will tend to hold a higher proportion of cash. This will depress the growth potential in the fund.

Conversely, in less buoyant markets large commercial properties can become very difficult to sell. In these circumstances, there can be a delay (of up to XX months) in cashing in the investments in a property fund. This means that there is a risk that you can't get hold of your money at the time that you want or need it: this is called a 'liquidity risk'.

Some funds don't buy property themselves, 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 markets will be reflected in the share price.

## The amount invested in smaller company shares

Market capitalisation – the number of shares on issue multiplied by the share price – is the generally accepted measure of a company's size.

One of a trio of terms commonly used to rank companies according to their size, the others being 'mid cap' and 'large cap'. 'Cap' is short for 'market capitalisation' which is calculated by multiplying the number of shares which a company has in issue by the current market price. So a company with 500 million shares in issue and a share price of 50p has a market cap of £250 million.

This would probably make it a small cap, but there are no fixed rules about where the thresholds lie. 'Small cap', for instance, can refer to companies with market capitalisations of just £50 million or as much as £500 million.

Of course, market cap is a moveable feast. If an AIM company is tipped in a Sunday newspaper, and its shares rise 30%, its market cap might leap from one side of the threshold figure to the other. Overnight it could turn from a small cap to a mid cap, even though its sales and earnings are the same.

'Small cap' investments tend to be far more volatile than those in larger companies. Relatively small events – winning or losing a contract, a positive or negative piece of 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 of smaller companies shares, liquidity can be poor, and the bid-offer spreads can be wide. There is a risk that, when you want to move money out of small companies, it can take time to do so, and the price at which buyers are prepared to take them is a lot lower than the price at which you bought.

## 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.

The Financial Express Crown Ratings are a quant-based ratings system designed to highlight funds that have had superior, consistent performance in relation to risk, relative to their peer groups, the fund sectors as defined by the IMA and the ABI.

Crown Ratings are compiled using three key measurements of a fund's performance – alpha, volatility and consistency.

The ratings cover UK authorised unit trusts and open-ended investment companies (OEICs). They are based on quantitative historical performance measures, and funds are ranked within their own sectors. The lowest rated funds in a sector carry a single crown, and the highest are awarded three crowns.

### **Financial Express Crown Rating 3** 🏰🏰🏰

These represent the top 20% of funds in their sector. By definition they will have demonstrated a good, if not excellent, record across the three performance criteria.

### **Financial Express Crown Rating 2** 🏰🏰

This rating goes to the next 30% of funds in the sector. Here we are looking at performance that 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, although this could be the case. Equally, 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 a pointer towards funds that are worthy of further investigation. Past performance is not a guide to the future. The value of investments and the income from them may go down as well as up and are not guaranteed. You may not get back the amount originally invested.

### **Non-rated funds**

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

- it has 3 years track record
- its history is accurate and consistent
- it is in a sector of 10 or more funds
- it does not belong to specialist or unclassified sector.

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