How Ellis Bates Help You Consider Risk When Investing

Enhancing people's lives

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FINANCIAL ADVISERS

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Contents

> Ellis Bates are here to enhance people's lives by delivering peace of mind, enabling financial freedom and helping clients achieve their goals.

Why is Your Attitude to Risk so Important?

When you invest your money the most important issue is your attitude towards risk and capacity for loss. Clearly, no one wishes to lose money, but most people are aware that for additional gain there is always increased risk.

Volatility

The primary measure of risk is the volatility of annual returns for a given asset. For example, a high risk asset such as an Emerging Market Fund may give good annualised returns over a ten year period, but the price of units are likely to change dramatically over the short term in either direction.

Conversely, a lower risk asset such as a fixed interest fund would probably give a much lower annualised return but would not fluctuate as much in the short term.

Unfortunately you can't rely on volatility alone. Reliance on volatility could result in the selection of investments that go against your risk profile, including for example complex assets. In addition to volatility, it is important to consider other factors including inflation, liquidity, diversification and specific risks.

Inflation

Inflation risk is the risk that the buying power of your capital decreases over time. A typical example of this is when you invest all your funds into one building society and the net return does not keep pace with the rise in retail prices. This means that in real terms your money is actually losing value.

Liquidity

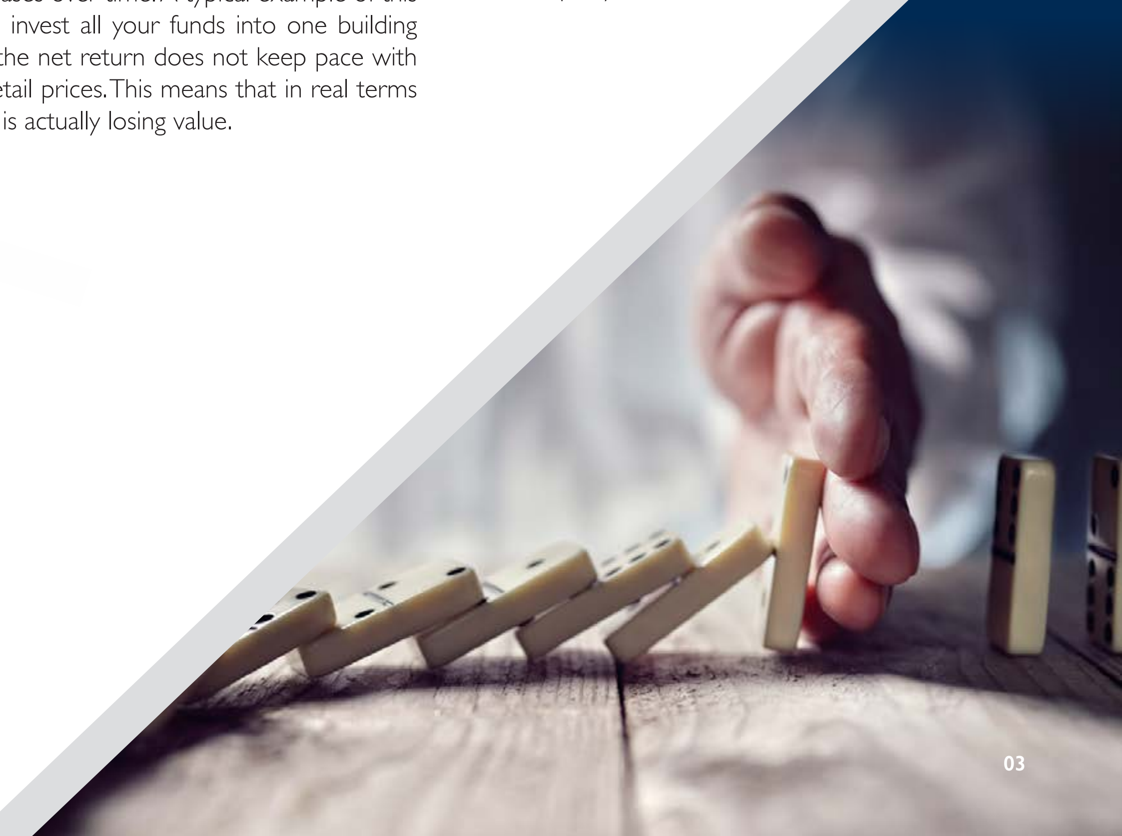
Liquidity risk arises from situations where you are not able to cash in your investments and therefore your funds can become locked in for a period of time or there may be penalties imposed on early surrender. Typical examples of this are shares which are not traded daily, or when demand is low, such as a property fund where the sale of assets is needed in order to realise your investment in cash.

Diversification

In order to reduce risk you should invest in a variety of assets. Diversification is the "free lunch" of finance. It means that you can reduce market risk simply by investing in many unrelated instruments such as shares, fixed interest, property and cash. The concept is often explained with the age-old saying "don't put all your eggs in one basket."

Specific Risks

This type of risk is the most difficult to quantify and should probably be avoided if not understood. An example of this is a complex fund not regulated by the Financial Conduct Authority or a structured product which is underpinned by a counterparty.



Our Risk Assessment Process

We ask you to complete a Risk Questionnaire. This allows us to prepare a report which is the first stage in determining your overall appetite for risk and capacity for loss in respect of your investments.

In order to assess and manage investment risk there is a four step process which is highlighted in the diagram below. The purpose of this report is to help you and your Adviser understand the risk associated with investing and correctly apportion risk to each individual investment or goal.

Step 1

This report has been prepared based on your answers to the risk questionnaire which is the first stage in determining your overall appetite for risk and capacity for loss in respect of your investments.

Step 2

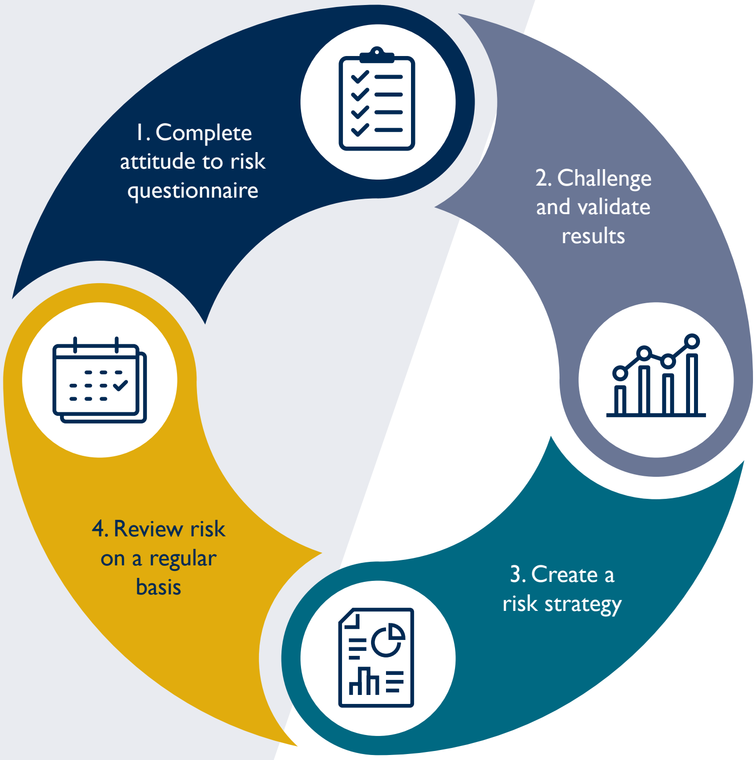
All risk profiling tools have limitations. This step is important because it allows your Adviser to challenge your views, validate your results and resolve potential conflicts in answers to different questions. The two most important outcomes are establishing your true attitude to risk and actual capacity for loss.

Step 3

There is much skill needed in order to distribute risk over your investments in order to give the most efficient result and your whole situation needs to be assessed in order to do this correctly. For example, if you are a 'medium risk' investor you could invest in National Savings Index Linked Certificates as a guaranteed hedge against inflation without the need to pay tax, but this investment would be one on a scale of 1-10 of risk. You could also invest in international equities which may be as high as 8-9 on a scale of 1-10. This investment is clearly higher than the stated attitude to risk of medium. However, this investment style may prove useful in order to harvest your annual Capital Gains Tax allowance and minimise tax on dividends. In conclusion, this simple example illustrates the efficiency in 'blending' risk because, not only have you maintained a 'medium' risk profile overall, you have also used the most efficient solution for your own circumstances and tax status. A further consideration is other areas such as debts. There is little point in implementing an investment portfolio if you have debts where the interest paid out is likely to be more than the net returns received from your investments.

Step 4

Asset classes do not move in synchrony and markets can be erratic. In order to maintain your overall risk, investments will need to be reviewed and rebalanced regularly. If this is not done, a portfolio is likely to drift over time which is likely to increase risk. Most importantly, you should inform your Adviser if your circumstances change as this will undoubtedly have a bearing on your appetite for risk and capacity to withstand loss.



Asset Allocation

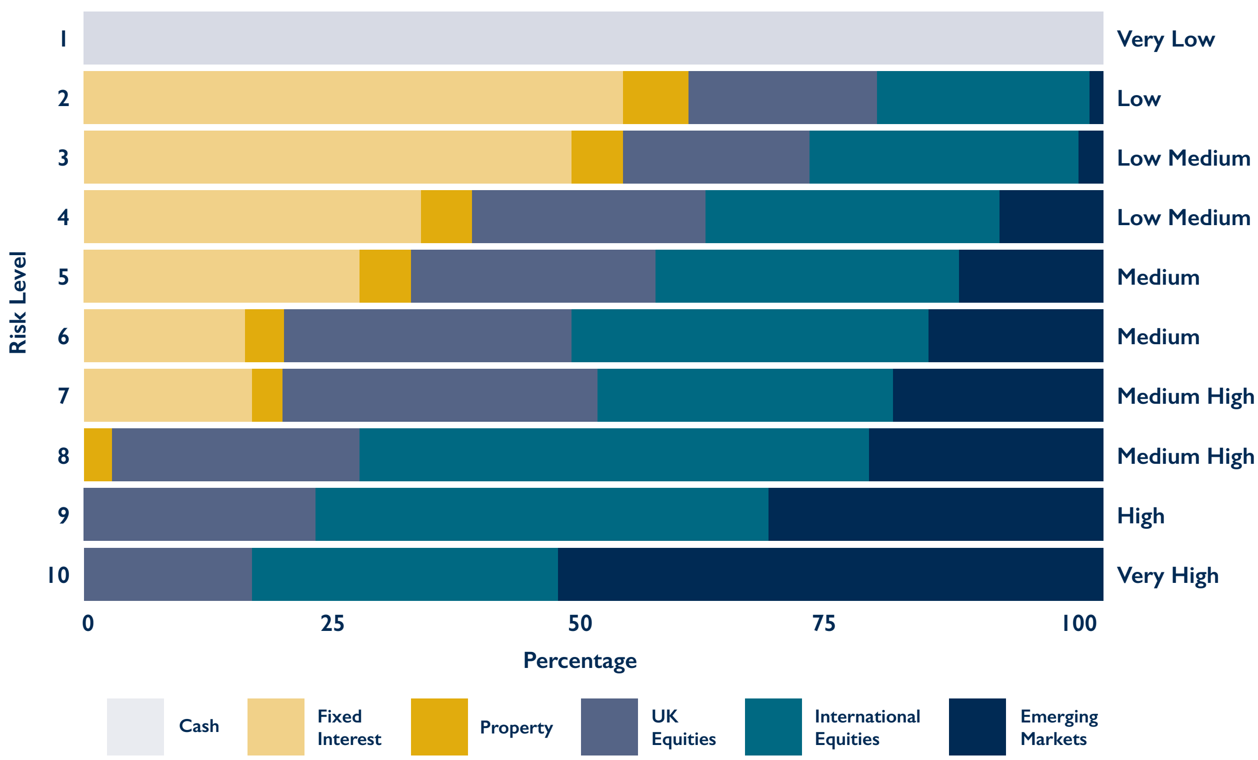
A large part of financial planning consists of finding an asset allocation that is appropriate for a given investor in terms of their appetite for, and ability to shoulder, risk. Asset allocation, done well, is a plan to invest in assets or asset classes which will best meet the needs and objectives of the investor.

Investors seeking high returns and willing to expose their investments to an elevated amount of risk will usually allocate to equity investments. Investors seeking stability and income will usually allocate to fixed interest investments.

Most investors, particularly personal investors, will find a blend of assets meets their needs. Asset Allocation can be practised by optimisation techniques, minimising risk for a given level of return or maximising return for a given level of risk. It also can be accomplished as goal based investing.

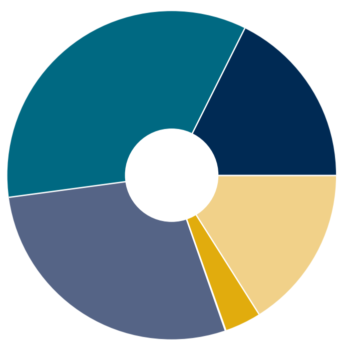
The primary goal of a strategic asset allocation is to create an overall asset mix that will provide the optimal balance between expected risk and return for a long-term investment horizon.

Example of blend of assets for given level of risk



Example portfolio construction for a level 6, Medium Risk Investor

Asset Allocation



Ratios for the above asset allocation

Example Volatility	12.00% - 14.00%
Example portfolio based on value	£10,000.00
Potential 1 year loss	£1,782.00
Potential 1 year gain	£2,140.00
Suggested Time Horizon	7 years +
Actual Historic Return based on sector average	6.65%
Possible Target Return	7.50%

Financial Ratios

Risk Level	Example Volatility	Potential loss over 1 year	Potential gain over 1 year	Example Target Return	Potential Time Horizon	Risk description
1	0.00% - 3.00%	£15.00	£406.00	4.00%	None	Very Low
2	3.00% - 6.00%	£241.00	£873.00	4.50%	1 year +	Low
3	6.00% - 8.00%	£845.00	£1,426.00	5.50%	3 years +	Low Medium
4	8.00% - 10.00%	£1,114.00	£1,588.00	6.00%	5 years +	Low Medium
5	10.00% - 12.00%	£1,453.00	£1,846.00	7.00%	6 years +	Medium
6	12.00% - 14.00%	£1,782.00	£2,140.00	7.50%	7 years +	Medium
7	14.00% - 16.00%	£1,828.00	£2,298.00	8.00%	8-10 years	Medium High
8	16.00% - 18.00%	£2,390.00	£2,715.00	8.50%	10 years +	Medium High
9	18.00% - 20.00%	£2,577.00	£3,224.00	9.00%	12 years +	High
10	20.00% - 100.00%	£2,902.00	£3,857.00	9.50%	12-15 years	Very High

The above analysis uses financial ratios which are measures that help us to analyse the performance of the underlying asset allocation of a generic portfolio over the last 20 years. It is not a specific analysis of any product or portfolio and can only be used as a guide.

We use financial ratios to stimulate discussion and help you develop greater understanding of risk and return. The ratios used in this table are explained below:

Example Volatility

The most common measure of volatility is simply the variation of the average annualised return. It does not necessarily represent how much a portfolio can rise or fall by but presents one of the best measures for portfolio risk. The example of volatility above is only a benchmark for an investment professional and actual volatility could deviate either way depending on market conditions.

One obvious limitation of this approach is investing outside of a well defined portfolio in an asset with a specific risk. For example, a guaranteed income plan will have a very low volatility (on par with cash) but maybe subject to institutional failure of the counterparty backing the plan.

In this instance the resultant 'volatility score' will be skewed because it does not take into account-specific risks and this is where the skill of the adviser and due diligence are very important.

Potential loss over 1 year

This analysis is so important because it highlights the worst historical calendar year return in the last 20 years using generic asset classes. The question to ask yourself is what you would do if your investments fell by this amount over 1 year?

Potential gain over 1 year

Conversely, the potential gain highlights the best historical calendar year return in the last 20 years using generic asset classes. You should probably ask yourself the same question as before, what would you do if you enjoyed this return?

Example Time Horizon and Target Return

The potential long term return gives you an idea of the type of return you might achieve given the potential time horizon and takes into consideration the performance of the underlying asset classes over the last 20 years. There is of course absolutely no guarantee of future returns and it is important to understand the potential for loss especially if you have to cash in your investment prematurely.

Risk Level vs. Risk Description

Risk level Descriptions provide your adviser with a more sensitive measure which will allow them to build up to 9 portfolios for each of your investment goals or attitude to risk. Risk Descriptions allow slightly more freedom within the Cautious, Balanced and Moderately Adventurous Profiles which are effectively a blend of two levels.

A wider range of volatility is useful because it allows Discretionary Fund Managers to 'map' their portfolio characteristics to your chosen style. For example, you might ask your adviser to manage a portfolio given your 'balanced' attitude to risk which is the same as asking your adviser to manage risk spanning risk level 5 and 6.

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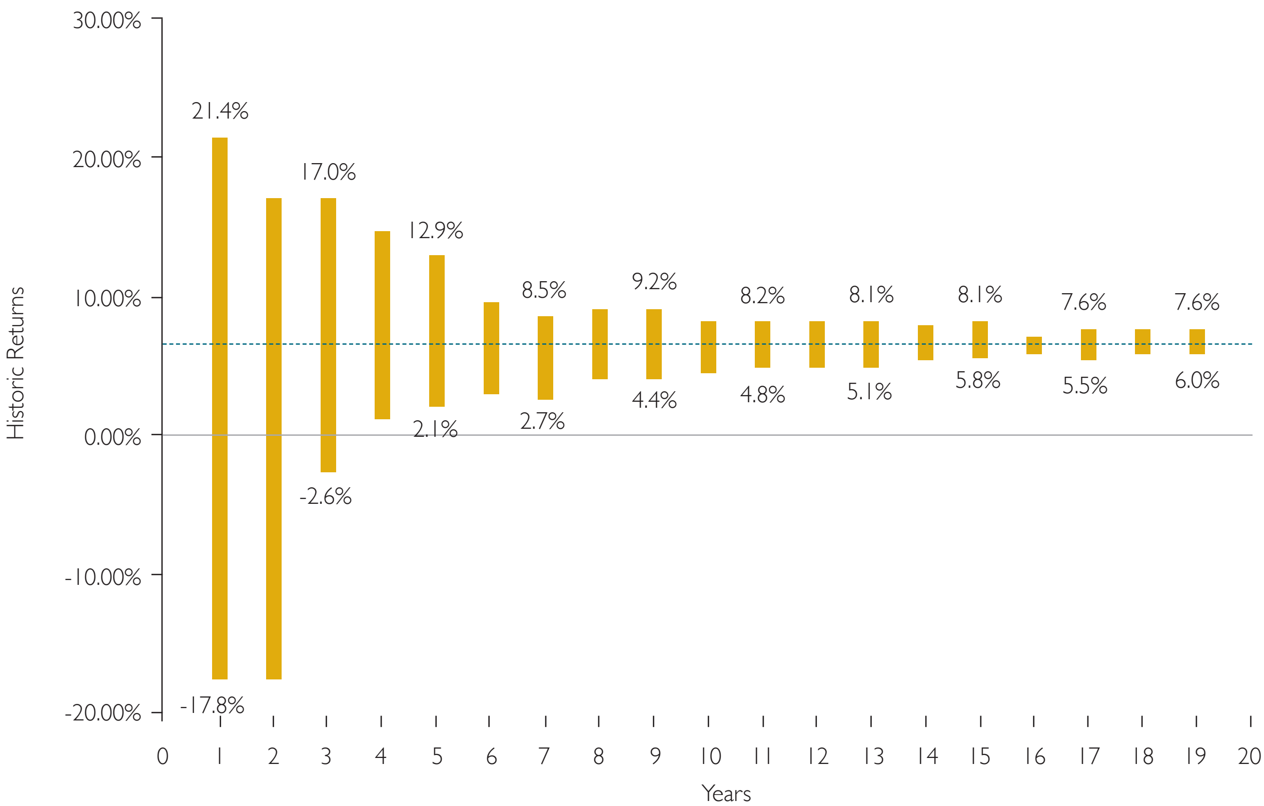
Example range of annualised returns for risk level 6



What does the above chart illustrate?

The above chart plots the best and worst discrete annualised returns over the last twenty calendar years using the example asset allocation in section 5.

For example, if we look at every 1 year period during the last twenty years, then the best year would have produced 21.4%, and the worst would have produced -17.8%. Therefore the range of returns is 39.2%.

If we annualise every 11 year period, then the best 11 year period would have produced an annualised return of 8.2%, and the worst 11 year period would have produced 4.8%. Therefore the range of return has reduced significantly to 3.5%.

Annual Return

The green line on the above chart shows us what the average long term return would have been for the example of asset allocation. In this instance the average return for this portfolio type would have produced 6.65%.

Corridor of Return

The above chart illustrates quite succinctly that returns are erratic but the corridor of returns narrows through the years. In other words risk is diluted with time and this can be very useful when planning which investment portfolio would be right for your own goals.

Capacity for Risk

As part of the process of establishing your attitude to risk and determining the suitability of various potential investment risk profiles, it is important to consider what is called your "capacity for risk". Your capacity for risk is the degree to which your personal circumstances and opinions will impact the specific investment decisions your adviser recommends.

When you align a risk level to each of your investment goals it helps to consider four areas: investment timeframe, debt repayment, your capacity for loss and investment liquidity.

Investment Timeframe

For each investment you make it is important to establish when you intend to cash in or use the invested funds for another purpose. Typically, this would be a short term of less than five years, a medium term between 5 and 10 years and a long term for any investments greater than 10 years.

Many people simply don't know when they might need access to invested money but where this is in doubt you should always consider a lower risk investment until you can confidently commit to a longer period.

Debt Repayment

As a general rule, before undertaking any investment, you should consider if it would be better to repay debts you may have. This is particularly relevant where these debts are subject to a high rate of interest, such as credit cards as it would be unlikely that investment returns would beat the rate of interest.

You will also need to consider if you pay debts out of taxed income. For example, if you pay a mortgage from taxed income and also pay 40% tax on your savings you will need a minimum gross return which is 67% higher than your chargeable rate of interest just to break even.

A final consideration would be an increase in the rate of interest at a later stage. Clearly, if interest rates rose significantly in the future and investment returns went down this would have a very negative effect if you needed to realise your investments to pay off the debt.

> "It is key to align your risk ratio to your investment goals"

Your Capacity for Loss

Your capacity for loss could be summarised by how much you could lose without having a significant impact on your current and future standard of living.

If your capacity for loss is very low you should consider reducing the risk associated with your portfolio. In all cases you should consider the downside risk of any investment you make and understand the potential range of outcomes.

Where you have significant sources of income which are not dependent on your capital, your capacity for loss would usually be very high and subject to your own tolerance for risk, a higher risk portfolio could give excellent returns over the longer term.

Investment Liquidity

If you need immediate access to your funds then taking any investment risk is usually not an option. By maintaining a suitable emergency fund, investments will be able to run for their term where risk would be naturally diluted. In some cases you may be able to maintain a cash base within an investment platform which may provide the desired liquidity but would be unlikely to provide a competitive rate of return over the long term.

Limitations of this Report

Strategic Asset Allocation vs. Tactical Asset Allocation

The data in this report looks at long term portfolio returns which are based on what we call 'strategic asset allocation'. A talented Fund Manager could in theory 'read the market' and go overweight (buy more) or underweight (buy less) of an asset class in order to maximum return or minimise risk. This is known as 'tactical asset allocation' but in theory this might actually increase risk because they could of course get it wrong.

Fund Selection

The analysis of returns does not take good fund selection into account. It is the job of the Adviser to select investment solutions which outperform the sector average used in this report. In theory, good fund selection should outperform the sector average but again the Adviser could get this wrong and returns could be lower.

Charges

The charges used in this report assume that standard retail charges were applied within the funds that make up the underlying sectors. In theory, many of these funds would be available to your Adviser at a significant discount which would increase return. Equally, any remuneration paid to your Adviser from the fund would decrease returns.

Unforeseen Events

The effect of previous unforeseen events is clearly inherent in any past performance statistics. The question is how unforeseen events in the future will alter returns. World events such as natural disasters, political unrest, terrorism and war have always presented a downside risk to your investments.

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"Provides a clear and excellent service that really helps the client to understand the market and be able to make the right decisions through providing your risk/reward investment strategy. This provides confidence for the future, trust, security of investments and it's a pleasure to have a review discussion and catch up with your IFA."

"Friendly service and a knowledgeable Adviser is essential and Carl Hasty of Ellis Bates gave my wife and I just that. We are keen on keeping a grip on our finances but are not particularly experienced in making investments beyond the current commercial and low-interest products available. Carl put us at ease and explained what would suit given our age, future needs, and attitude to risk. His work was backed up by an efficient backroom office and a feeling that any future query was welcome backed by an annual assessment."

> With offices throughout the UK your Adviser offers face to face, video and telephone meetings, tailored to your preferences and schedule.

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