Penguin

The Advanced Investment Strategy (AIS)

ADVANCED INVESTMENT STRATEGY PERFORMANCE

At Penguin we have created a process to manage our clients' investments, the Advanced Investment Strategy (AIS). Our approach is to focus on the reduction of risk, which if managed correctly will inevitably produce better performance.

When the majority of people analyse investment performance they tend to look at the returns achieved by the FTSE 100 - an index composed of the 100 largest companies listed on the London Stock Exchange. These are often referred to as 'blue chip' companies, and the index is seen traditionally as a good indication of the performance of major companies listed in the UK.

The chart and subsequent graph below show the performance of the FTSE 100 Total Return Index* against the performance of our AIS over the last 20 years. The benefits of our strategy, over time, become quite clear.

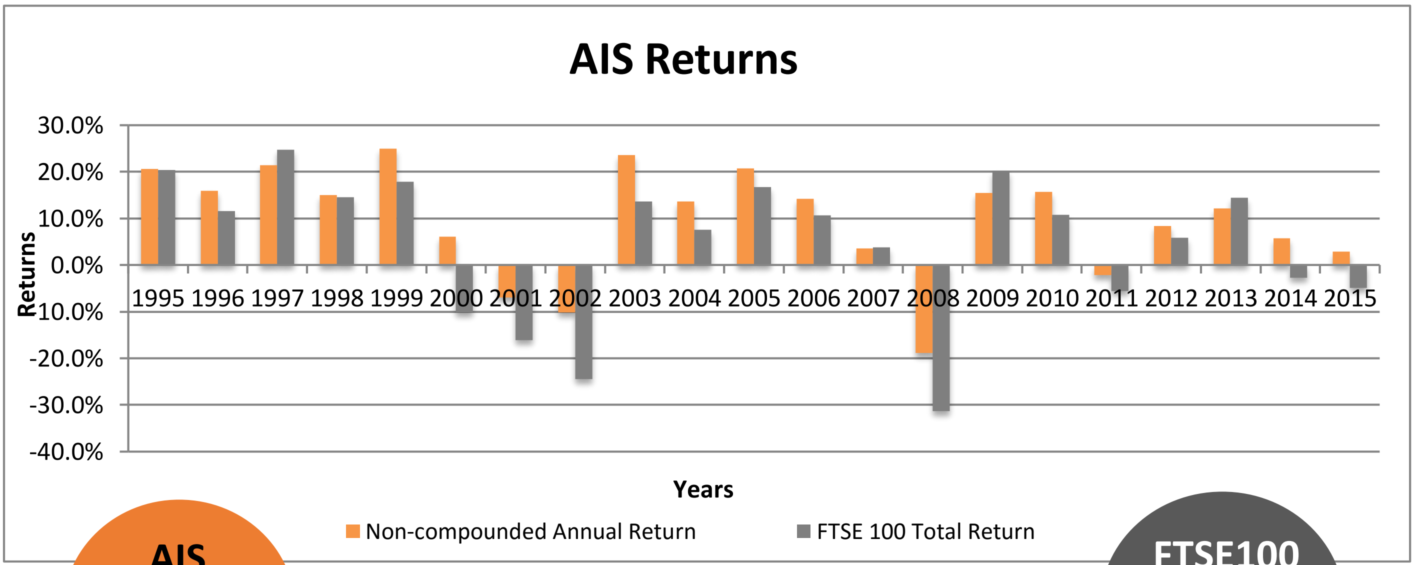
***FTSE 100 Total Return Index** - measures the total return of the underlying FTSE 100 index, combining both capital performance and income.*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Low Risk	13.12%	17.28%	20.11%	5.70%	9.62%	10.29%	1.97%	2.10%	17.87%	16.47%
Medium Risk	22.74%	12.41%	27.04%	22.27%	25.72%	1.73%	-9.96%	-18.93%	23.12%	13.84%
High risk	35.94%	17.76%	16%	27.51%	62.38%	2%	-24.59%	-27.43%	38.82%	6.36%
AIS Annual Return	**20.6%**	**15.9%**	**21.4%**	**15.0%**	**25.0%**	**6.1%**	**-6.9%**	**-10.1%**	**23.6%**	**13.7%**

FTSE100 Total Return	20.35%	11.63%	24.69%	14.55%	17.81%	-10.2%	-16%	-24.48%	13.62%	7.54%

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Low Risk	11.37%	13.91%	-7.77%	-12.20%	5.48%	8.27%	5.54%	3.97%	8.89%	7.24%	4.11%
Medium Risk	27.06%	22.70%	9.37%	-26.90%	13.82%	17.19%	-5.62%	14.25%	27.63%	5.16%	5.09%
High risk	34.87%	2.22%	23.22%	-23.40%	42.83%	31.91%	-16.39%	10.64%	-2.92%	3.03%	-3.2%
AIS Annual Return	**20.8%**	**14.2%**	**3.6%**	**-18.9%**	**15.5%**	**15.7%**	**-2.2%**	**8.4%**	**12.2%**	**5.8%**	**2.9%**

FTSE100 Total Return	16.71%	10.71%	3.80%	-31.33%	20.16%	10.73%	-5.55%	5.84%	14.43%	-2.71%	-4.93%



AIS Average 9.6%

FTSE100 Average 4.6%

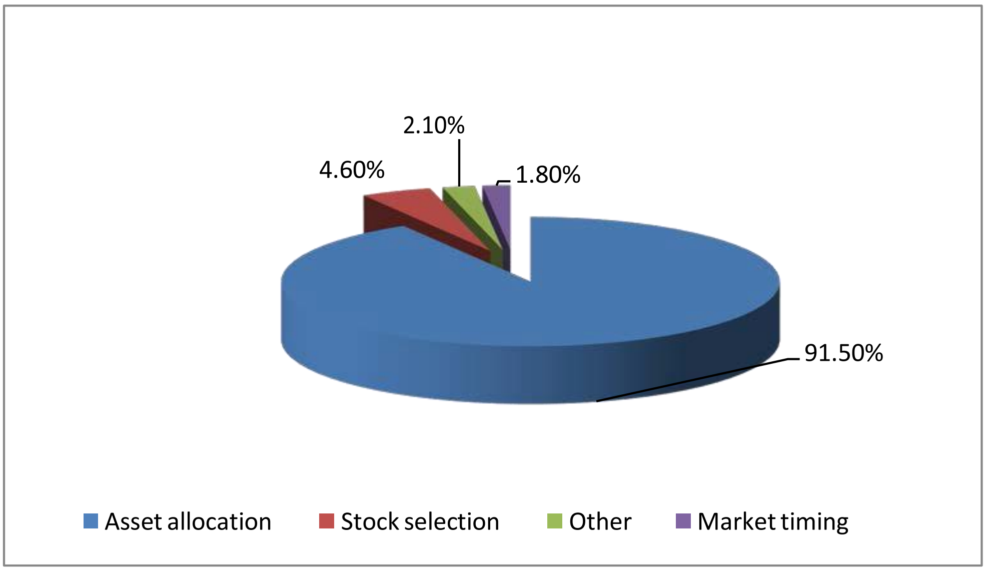
THE ADVANCED INVESTMENT STRATEGY

There are many different views on how to invest. Most people focus on the “Buy low and Sell high” philosophy, or the simple holding approach, or even worse, have no strategy other than following the media. Our approach is to focus on the reduction of risk, which if managed correctly will inevitably produce better performance.

In developing The Advanced Investment Strategy, we reviewed the many different ways of investing. However, no matter how many techniques, systems or ideas, we always came back to the same set of sound investment principles that work over the long term.

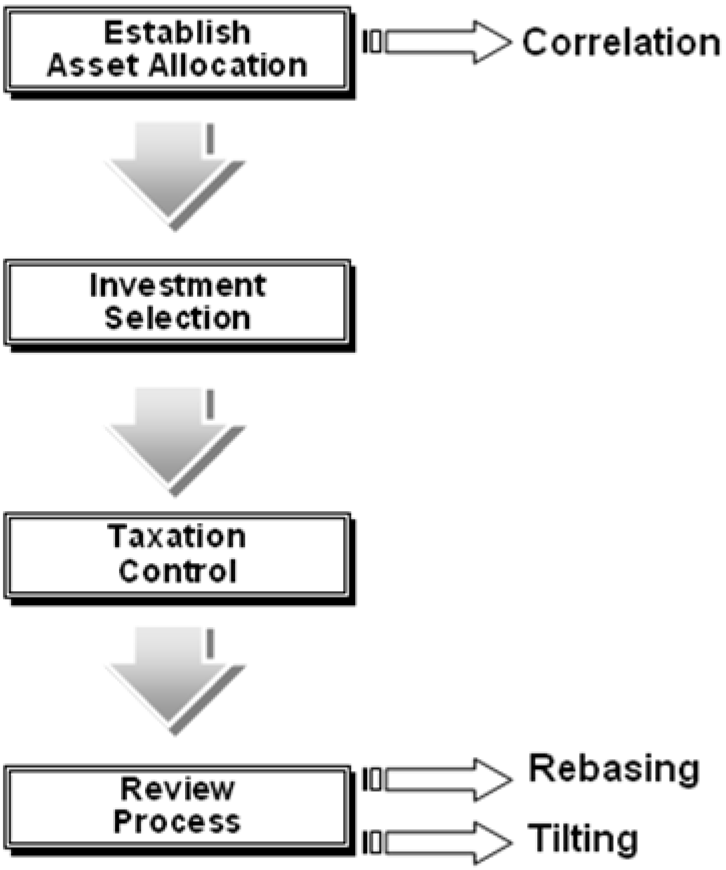
The Advanced Investment Strategy has been built around the Markowitz model. Harry Markowitz won the Nobel Prize for economics in 1990 by developing an investment strategy built around asset allocation.

The Advanced Investment Strategy is successful because it works on the understanding that successful investing is 90% asset allocation and 10% investment choice, as you can see below. Too many people focus solely on investment choice, when asset allocation is the prime cause in successful long-term financial plans.



Source: Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, Determinants of Portfolio Performance The Financial Analysts Journal, July/August 1986.
Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, *Determinants of Portfolio Performance II: An Update*,The Financial Analysts Journal, 47, 3 (1991)

The Advanced Investment Strategy can be outlined as follows:


Establish Asset Allocation
Correlation
Investment Selection
Taxation Control
Review Process
Rebasing
Tilting

As you can see the Strategy selects and creates a portfolio that is totally unique to you, based upon defined investment and risk criteria, and then ensures that this criteria is reviewed and amended to make sure that you can benefit from changes in the investment markets.

The Strategy has four separate stages:

Stage 1 - Allocation

The first stage is the most important and revolves around asset allocation and risk allocation.

Asset Allocation

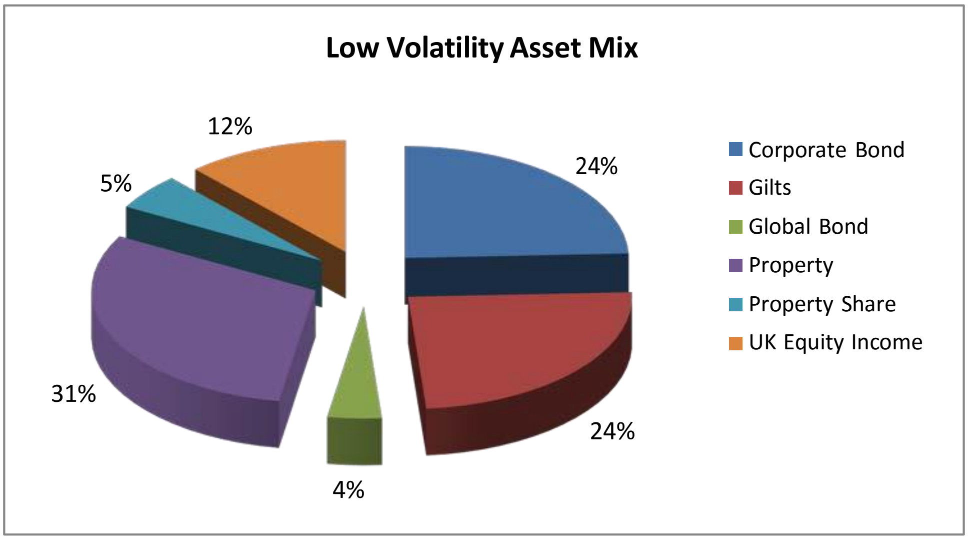
Asset allocation is the process whereby each of your investments are designed to complement each other. In the most simplistic terms, as some investments go up others go down. By having the correct mix of investments you can radically reduce the level of risk of your investments, and at the same time increase the performance.

You, like most people, will have investments which have not been chosen with reference to each other, but chosen individually. This means that within any portfolio “double counting” will occur. When you have double counting you will have too many or too few of each individual investment.

The asset allocation process is one which we spend many hours constructing, reviewing and amending. To make it easier to understand we break investments down into three different areas; low risk, medium risk and high risk. At the present time the individual risk areas of asset allocation are as follows:

Low/Cautious Risk

Based on a risk tolerance of 5 out of 10, Investments into this area will constitute 57.5% of your Portfolio and should be mixed as follows:



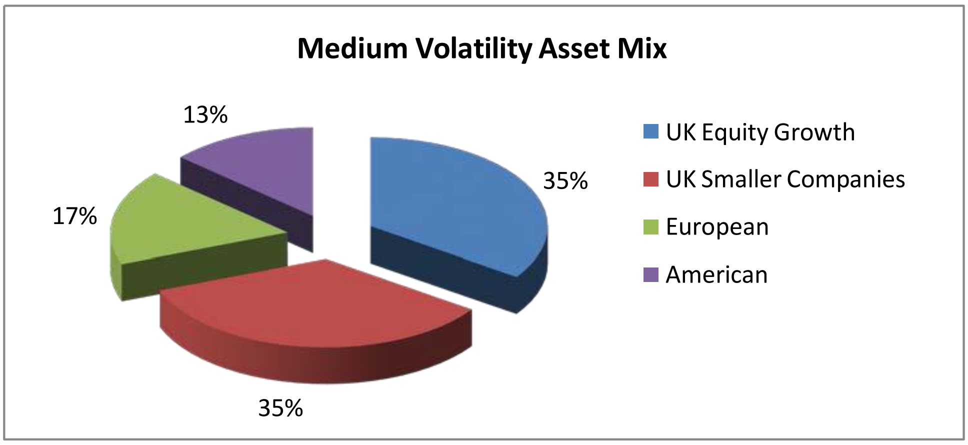
Low risk or cautious investments are not no risk investments. With the exception of indexed gilts held to maturity and Indexing National Savings, all investments have some form of risk. The objective of the low risk portfolio is to reduce risk to a very low level and at the same time increase returns when compared to the benchmark of the 90 day Halifax deposit rate.

Over the short term, the value of the low risk portfolio, will fall and rise. In the longer term, we would expect the low risk portfolio to show a positive return, however, despite this you must remember this is low risk not no risk.

The low risk portfolio only includes 48% in shares, in this case property company shares and UK Equity shares. 52% of the assets, as you can see, are not invested in the “markets”. This means that over the longer term, a low risk portfolio will produce a lower return than the medium and high risk portfolios, but will not have the volatility that is inherent in the other portfolios. It is the combination of assets that reduces the overall risk, and not the individual assets themselves.

Medium/Realistic Risk

Based on a risk tolerance of 5 out of 10, Investments into this area will constitute 26% of your Portfolio and should be mixed as follows:

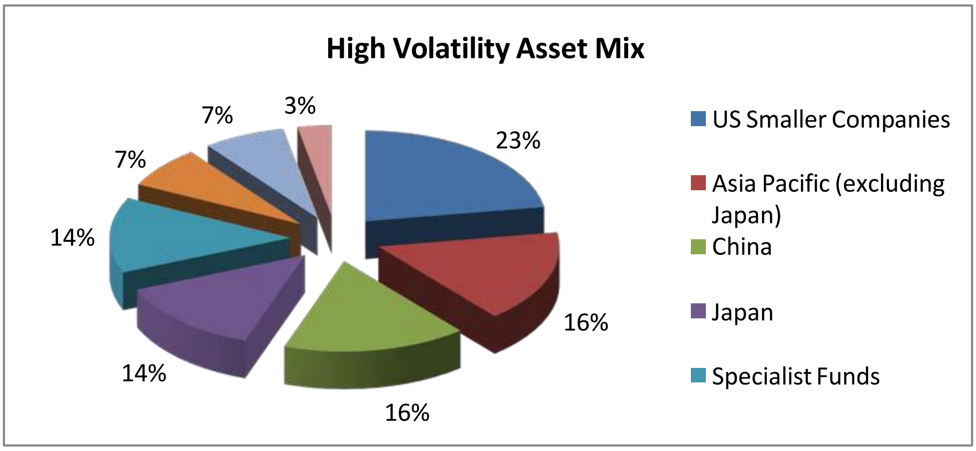


Medium level investments will typically perform better than lower risk investments over the longer term. However, they will be more volatile in the shorter term. This will mean that the value of the capital will fluctuate. In our experience this fluctuation can move the value of the capital by 5-10% on a daily basis depending on the movement of the underlying investments.

The medium risk portfolio contains entirely shares. The shares used tend to be larger companies, which are listed on one or more stock market. The medium risk includes UK, European and USA stocks. Like all stocks and shares the value of them, and consequently your investment, will fall and rise over time.

High/Adventurous Risk

Based on a risk tolerance of 5 out of 10, Investments into this area will constitute 16.5% of your Portfolio and should be mixed as follows:



Assets in the high risk area will normally outperform both the medium and low risk investments over a longer period. However, the assets can have a great deal of capital fluctuation, with daily movements of up to 20% or more.

The high risk portfolio includes many different investments in many different countries. The above pie charts show the present make-up of the three different portfolios for a Risk Profile 5 Investor; however, when you actually invest it is likely that the portfolios will look a little different as they change over time depending on the circumstances when you invest. This is covered below in the section on “Tilting”.

Risk Allocation

It is our job to create the asset allocation models that you can see above, where you come in is to decide and agree the Risk Allocation for your investments going forward.

Until we have had further discussions, and you have completed our Penguin Risk Questionnaire, for the purposes of this report and the AIS explanation, we have assumed that you have a risk tolerance of 5 out of 10.

Once you have completed the Risk Questionnaire, we will discuss the results of this analysis and agree on the specifics of your investment. If you decide to become a Client we will review this with you during your Review Meetings as part of our service. Of course we will also look to make changes if there are changes in the economy that may affect you, or if there are changes in your personal circumstances.

When you look at the performance figures that the AIS system has achieved since 1995 (see Appendix B), you can see that the high risk has produced better returns than the medium risk and the medium risk have produced better returns than the low risk. However it is very important to remember that high risk investments will have a greater level of volatility and risk than medium risk. Likewise the medium risk will have a greater level of volatility and risk than low risk.

Stage 2 – Investment Selection

Once the overall asset allocation has been decided we then need to actually select investments that can sit within each of the different asset classes. This means, if we are choosing to include a European Fund for example, we need to actually select a European Fund from all of those available on the market. This selection process uses a series of three different “filters” to choose the relevant investments.

When looking at investment selection it is prudent to consider Performance, Volatility & Charges. We indicated earlier that the majority of performance comes from the Asset Allocation of your investment, which we have covered.

There is lots of research that suggests an index is a safer way to invest. It is also cheaper! To that end, the Penguin portfolio generally invests in what is called a 'passive' or 'tracker fund'. This can change.

Stage 3 – Taxation Control

Taxation can have a dramatic effect on your investment portfolio. With UK taxation as high as 50% it is important to reduce this wherever possible.

As a general rule there are two types of taxation that we are considering with your investments. The first is Income Tax and the second is Capital Gains Tax (CGT).

The taxation system in the UK is very strange, and it is important to take account of the different taxation rules wherever you can.

We consider taxation a part of any fresh investments you make.

Stage 4 – Review

There are many things that may change how your investments are organised. However, within The Advanced Investment Strategy there are four that we must consider regularly:

1. Changes in investments
2. Changes in asset allocation / risk allocation
3. Rebasing
4. Tilting

1. Changes in investments

The performance of investments changes over time. Sometimes this is because the investment manager has failed to perform, it may be that the investment manager stops running the investments, it may be that the charges on the investment increases or decreases which will impact on the investment performance.

All of your investments, while we are working with you as a Client of Penguin, will be checked every day. Where it is appropriate, we will recommend changes to the funds held to take account of changes in the investments.

2. Changes in asset allocation/risk allocation

The asset allocation model, which we use, changes over time. These changes tend to be slow and are considered long and hard before they are made. Asset allocation requirements tend to change as economic and political circumstances change. Some of these can be predicted and some cannot. As these changes take place the asset allocation model must change to take these circumstances into account.

For example, as interest rates increase, returns on Gilts will usually fall in the short term as the existing Gilts become worthless, compared to high rated Gilts that may be issued. This would mean that in times of increasing interest rates, Gilt holdings would be reduced, and more money would be placed in the money markets. If interest rates were to fall, the returns on Gilts would tend to increase. This is because the higher interest rates on existing Gilts would become worth more, compared to new Gilts that are issued. Therefore, you would look to reduce money market holdings and increase Gilt holdings.

Therefore, every month we reconsider your asset allocation (the pie charts above) and consider how the percentages need to be changed.

The second area is the risk allocation. Over time your circumstances will change and you will want more or less risk within your portfolio. Therefore, the risk allocation will be amended as it is appropriate.

3. Rebasing

Over time your investments will become bent out of shape. This is because all of your investments are independent and will change in value based upon their underlying performance. This means that the carefully balanced investments that we initially set up, and the carefully considered risk allocation that you agreed, become out of balance. This means that you have either too much or too little of an investment.

The process of rebasing is where the investments are brought back into shape. Rebasing usually takes place once or twice a year, depending on circumstances.

4. Tilting

When we set up your investments, a great deal of time is taken constructing the risk and asset allocation models. However, sometimes we need to make temporary changes to these different allocations to take account of what is happening in the real world.

The temporary changes tend be to proactive changes that need to be put in place to take advantage of or protect you from what we expect may happen in the investment world.

For example, your portfolio may have grown very quickly in a very short period of time because of an abnormal growth in the markets. Rather than leave the investments invested, it may make sense to "carve" out the abnormal growth, and hold it on deposit for a short period of time, with the view to re-investing when markets fall again.

Alternatively, we may be expecting possible falls in the market, due to economic or political reasons. In which case we may recommend a reduction in risk into the low risk area to help protect from these falls.

Changes which are made on a temporary basis to amplify gains or protect from losses are known as "tilting". By tilting we are looking to slightly move the asset allocation or risk allocation temporarily, before coming back to the centrally agreed allocation models