

Let's talk wealth management



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Risk and return are inextricably linked, so draw up your strategy carefully.

EVENTS over the past year have been very discouraging for investors and some may be questioning the wisdom of their investment strategy.

However, I believe a broadly diversified investment approach has made sense in the past, makes sense today and will continue to make sense in the future. Most importantly, this strategy provides the strongest foundation for an investment plan.

So what is the best strategy for managing money under adverse business conditions as well as more normal conditions?

The best investment strategies rest on the idea that markets of publicly traded securities are highly competitive. All this competition drives prices towards some intrinsic fair value, providing an appropriate degree of compensation reflecting the risk and return potential of every underlying enterprise. Put simply, there is no such thing as a free lunch.

If we want high returns on our investments, we must be prepared to bear high risk. If we want low risk, we must be willing to accept low returns.

So what do we do if we can't predict share prices or market trends? First of all, we broadly diversify our portfolio to minimise the risk of owning any single shareholding and, within a broadly diversified portfolio of shares, we seek to identify any simple fundamental risk factors that would explain why some broad groups of shares would behave differently from other broad groups of shares.

There are three broad risk factors that matter to investors:

1 EQUITY RISK

The risk of holding shares at all over the risk of owning safe, risk-free government bonds.

2 COMPENSATED RISK

Small companies are generally thought to be riskier than large companies and as a result investors demand higher expected returns to be persuaded to own them. Similarly, low-priced shares – so-called “value” shares – also are riskier in some way and so investors shrink away from these, demanding a higher expected return as compensation for owning them.



3 UNCOMPENSATED RISKS

An example of this would be an undiversified portfolio, or perhaps a major holding in just one company, such as Northern Rock or the Bank of Scotland.

Successful credit crunch investing is not about finding the next Microsoft, but about focusing on the less glamorous concept of diversification. Overconfidence and under diversification do not serve investors well.