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Season 2. Building personal wealth

Episode 10.

Reducing your investment worries with mixed investment funds

Hi there. Jason here. In this Insight we'll complete our look at ways to reduce the worry of investing your money, by looking at the risk reducing benefits of collective investment funds. And, in particular, at funds that spread your risk across different asset types.

There may be times for any investor, for example with your pension in the years before retirement, when you might not want all of your invested monies exposed to the full force of stockmarket fluctuations. And some people, with a very low tolerance for risk, who might prefer to limit their stockmarket exposure on all their funds – all the time. Mixed Investment funds can help in both of these areas. But before we look at mixed investment funds, let's look at the wider benefits of investing in collective funds.

When you invest the money inside your pension or Stocks and Shares ISA using collective funds rather than buying a specific share or basket of shares directly, you enjoy benefits in three main areas. Administration, costs and fund management. First, you don't have to consider and act upon the various corporate actions of the companies that you're invested in. Nor do you have to undertake the buying and selling of shares or account for and reinvest any dividends paid out on your shares. This is all taken care of by the administrators of your funds. Second, if you invest with a competitive investment or pension plan provider, your ongoing charges for fund management will be low and you'll enjoy low or no costs for moving your money between different funds inside your plan. Which you'll want to do from time to time to keep your investment risk exposure in line with your capacity for it. And it's this risk reduction feature which is arguably the biggest benefit of collective fund investing. We talked in an earlier Insight about how investing in the shares of just one company exposes your money to a risk of total loss if that company goes out of business. And how collective funds avoid this risk by pooling your money with other investors to buy a broad spread of different companies' shares, so that if one share within your fund crashes in price – the price of your fund only falls by a small percentage. A broadly based stockmarket fund will hold several shares in companies from any given sector of the economy and will hold shares in companies from many industry sectors too.

Funds that invest in just one or two sectors of the economy can be very risky. As we noted before with the funds that invested only in bank shares and were badly hit in the financial crisis. Or with the popular funds that invested only in technology companies but then lost about 90% of their value in less than 3 years in the dot com bust between 2000 and 2003. Of course, you could make a lot of money from these sector specific types of funds, but you can also lose a lot of money by investing in them too and they're certainly not good funds for lowering your risk exposure, which is what we're talking about here.

So, broadly based, collective funds can help you avoid being over-exposed to risks in specific companies or specific industry sectors. And you can achieve some risk reduction either by holding all the shares in your chosen market through an Index Tracking fund. Or through an actively managed fund. Or a mixture of the two. Index tracking funds may have an advantage in cost terms, and can work very well as a core holding, particularly when you don't want or need to generate returns that are higher than the overall stockmarket. However, you need to remember that full index tracking funds have to hold all the shares in all sectors of the market, at all times, even when a particular sector, like the technology or banking sectors we talked about earlier, have become expensive and is at risk of a severe correction.

So, at times of market exuberance, it might be worth paying a little extra for a fund that's actively managed by a professional fund manager who's focussed on finding shares at good value, and helping you avoid the overheated sectors. The challenge is in finding fund managers that consistently deliver good returns and control your risks too. The key thing to remember is that the right stockmarket fund for you will depend on what you want from your investment. So, for example, are you looking for income or growth, or a combination of both. And how concerned are you about the risk of wider stock market falls. Now, as I said earlier, most of us will have situations where we're concerned about stockmarket setbacks on our pension fund for example, in the years running up to our retirement, and it's in these situations where you might want to reduce your risk by mixing stockmarket and property type funds with some lower bond and cash type funds.

And that's what mixed investment funds are all about. In a typical mixed investment fund, the cash deposit element will provide capital protection and, in normal times, a small interest return. The bond element will, if managed well, provide slightly higher returns than the cash element with some but not as much risk as your real assets in the stockmarket or property. And it's these real assets – including the reinvested income - that should contribute the higher returns to your fund over time.

So, a well-managed mixed investment fund will capture some of the return on the stockmarket without exposing you to all the risk. And the investment industry now categorise their mixed investment funds to help you set a limit on your stockmarket exposure: of up to 35%; or 60%; or 85% of your fund value. Whatever suits your tolerance and capacity for investment risk. Alternatively, you can choose a mixed investment fund from the 'flexible' investment category which, as its name implies, gives the fund manager full flexibility – to invest up to 100% of the fund in the stockmarket.

It's up to you to decide if you want to put a limit on your stockmarket exposure. But, in thinking about that it's worth bearing in mind one further risk. The fund management industry is a competitive one and you need to be aware that towards the end of a bull market, when stock markets have been racing up in price, many active fund managers in the mixed-asset fund sector will be holding near maximum levels of higher risk/higher return assets in their funds. It's only by holding more higher risk/higher return assets that they will have (ordinarily) outperformed their competitors during the bull run. In other words, many funds will be holding similar (maximum) proportions of their funds in risky assets, right at the riskiest of times. So, you should avoid making fund choices solely on the basis of past fund performance during good times.

And look for mixed investment funds that also perform well and protect your capital during the bad times in markets. Because it's the capital protection you'll want from your mixed fund when the markets go down again. As we said throughout this series of insights, the key to good investment is to invest in line with your attitude to risk and, more importantly, your capacity for risk on each of your financial life goals. Use short term cash deposits and cash funds for money you're going to need within the next five years or so. Use stock market and property-based funds for longer term and regular investment plans. And seriously consider using mixed investment funds for situations where you still have time to invest but can't fford to have your fund values gyrating in line with the stockmarket. You need to have a solid framework and approach to your investing, both in terms of your choice of the right investment vehicle and the funds you hold inside them. And this is what we'll outline in the next Insight. So see you back here when you're ready for that. All the very best.

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