Invesco Expert Whitepaper

Designing an Investment Strategy

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More is lost by indecision than wrong decision. Indecision is the thief of opportunity. It will steal you blind."

Marcus Tullius Cicero

THE IMPORTANCE OF SETTING AN INVESTMENT STRATEGY

Following a decade where investment markets had been relatively smooth and serene, COVID-19 delivered a shock that provided a timely reminder of the importance of setting an investment strategy.

Those who had already established an investment strategy generally responded calmly to the crisis, without making panicked and rash decisions. For some who had not established an investment strategy, the panic caused from the COVID-19 crisis caused them to liquidate their investments with some investors crystallising losses at a low point in the market. For some, this liquidation occurred when global equities had sold off 33.8% peak to trough, in March of 2020 (measured by the FTSE World index, in euro terms). Subsequently, these investors who came out of the market and left their investment in cash suffered the initial fall caused by COVID-19, and were left on the side lines only to watch as the markets made a rapid recovery due to strong central bank and government support measures. To make matters worse, these investors were then faced with the uncomfortable decision of timing their re-entry into markets.

This recent activity highlights the importance of an investment strategy, because such a strategy helps mitigate indecision, the perils of which Cicero warned us about two millenniums ago!

WHAT IS AN INVESTMENT STRATEGY?

At its most basic, an investment strategy is having a plan for your savings. This plan should be based on both guiding investment principles and your personal circumstances, and should form part of your broader financial wealth plan. In this paper, we will provide a high level overview of a three step process to designing a long-term investment strategy:

1. Establish your investment objectives
2. Purchase assets in line with guiding investment principles
3. Assess whether your strategy continues to meet its objectives

The steps above are akin to purchasing and maintaining a relatively pricey asset, such as a car; establish what car you need, purchase that car and then carry out periodic check-ups and purchase a new one if/when required.

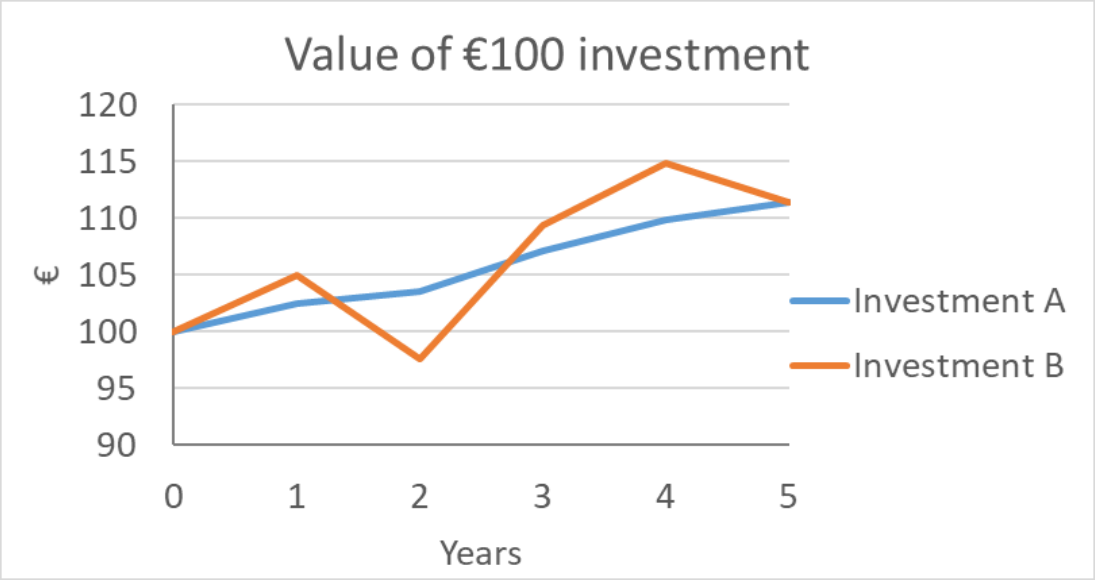
For many, setting an investment strategy can seem a like a daunting task, and investment strategies themselves can be complicated when you consider the many different assets available. Investment Consultants and Financial Advisers therefore play a major part in the development and procurement of investment strategies. At Invesco, we work through this process to find the strategy that is best for the client, at an individual or pension scheme level.

STEP 1 - ESTABLISH YOUR INVESTMENT OBJECTIVES

Whilst there are many aspects that can guide an investment strategy, we have summarised the three main factors below:

- **Your Goal –** For almost every investor, the ultimate goal is to maximise the investment returns earned. Unfortunately, competing factors complicate the pursuit of this goal.
- **Risk Tolerance –** Investors must be mindful of the level of risk they are taking on in the pursuit of investment returns. Behavioural research has found that most investors are risk averse and have a strong preference for investments which have a smoother journey.

  Both investments in the below chart grow from €100 to €111 after 5 years, however most investors would have a strong preference for Investment A as its returns path is smoother than Investment B. Many investors face a tougher time in realising the gains under Investment B as they may panic sell when their investment falls in value.



  For those implementing their own personal investment strategy, the toughest challenge is balancing the competing goals of maximising returns in line with their risk appetite. With this in mind, large advisory firms offer pre-packaged investment solutions that allow investors to select a fund that has a built in risk-rated investment strategy. Each strategy seeks to maximise investment returns according to various levels of risk tolerance (covered in more detail in Step 2 below).

  The right investment strategy also depends on your investment time horizon. For younger investors, they can generally accept more investment risk if they are willing to take a long-term view. Over very long term time periods, certain investments have demonstrated their ability to provide higher returns. The short term price swings of these investments should be of lesser importance if the long term direction of travel is upwards.

STEP 2 - PURCHASE ASSETS IN LINE WITH GUIDING INVESTMENT PRINCIPLES

Once investors have identified their overall investment goal, the next step is to implement their investment strategy in the form of the assets purchased. This is typically done by investing in an investment fund or a basket of investment funds. At this stage, investors have a choice between two approaches:

1. Pre-packaged solutions

A high level overview of the process for designing a tailored investment strategy is provided below, however, many feel they lack the expertise to follow such an approach. Selecting the most appropriate assets can require an understanding of the characteristics of several asset classes, and evaluating the funds within each asset class correctly is also complex and time consuming.

The good news is that investment managers and advisers have recognised the needs of investors for pre-packaged risk-rated investment solutions. They perform the required due-diligence across an array of asset classes and funds, and they then utilise investment modelling techniques to determine the optimal mix from the asset classes they have shortlisted. These funds generally have the goal of maximising returns within defined risk parameters, also seeking to draw on the benefits of diversification.

2. Tailored solutions

Some investors with more financial knowledge (either their own or drawing on the advice of investment professionals), seek to design an investment strategy that is tailored to the nuances of their circumstances. Whilst there can be many considerations in this approach, a key decision is around the split between growth and monetary assets as this is a major driver of performance. Included below is a high level summary of the main growth and monetary asset classes.

Tailored solution – overview of asset classes
Growth assets describe asset classes which have demonstrated an ability to outperform over cash and bonds over the longer term; however, they typically experience more ups and downs along the way, and the range of these ups and downs is measured by volatility. The most common investments within this area are:

- **Equities**
  An equity (or share) is a stake in a company either in Ireland or overseas. If the company makes a profit, it shares those profits with shareholders (through dividends). If you invest in equities (shares), the money you make on your investments (returns) is based on the dividends you get paid plus any capital gains you might make from selling your shares at a higher price than you paid for them. You might lose money from selling your shares at a lower price than you paid for them.

- **Property**
  Property includes a wide range of office, retail and industrial properties, amongst others. If you invest in property, the money you make on your investments (returns) is based on property values and rental income. Property tends to be lower risk than investing in shares but higher volatility than cash and bonds.

- **Infrastructure**
  This is an alternative way of investing your savings. Infrastructure typically covers spending on new construction projects or improving existing networks. Examples of infrastructure investments range from road, rail, ports, airports and universities. Typically, money is provided to support the construction of these projects and investors receive regular repayments once it is completed. For example, a new road could be built with money secured from a pension / investment scheme and the lenders would repay the scheme through the collection of road tolls.

Monetary Assets:

- **Bonds**
  A "government bond" is a loan to a government. In return for these loans, the government pays interest. Government bonds are considered higher risk than cash, but lower risk than growth assets. "Corporate bonds" are loans to companies, banks and large organisations. Interest is usually paid on the money borrowed. Incorporated into the interest paid on bonds is the risk of default by the borrower (corporate bonds are considered higher risk than government bonds). Both government bonds and corporate bonds can also lose value.

- **Cash**
  Cash is considered to offer a lower risk of capital loss compared to higher risk asset classes. If you invest in cash, the money you make on your investments (returns) is based on the interest rate offered by the borrower you lend to. The longer term investment returns offered by cash are lower than other asset classes and therefore investing in cash is usually not considered a good long-term investment strategy.

Tailored Solution: How to mix asset classes by using a strategic asset allocation

Once an investor has selected the growth asset funds and monetary funds that complement his objectives, the next step is figuring out how to allocate to these funds in a way that provides the desired return within defined risk parameters. Typically, this is done by setting a strategic asset allocation whereby he defines his desired mix of assets, for example 50% growth assets and 50% monetary assets. He could further define the split between the various growth funds and monetary funds he has shortlisted for investment.

At one stage, this approach could be simplified as a strategic allocation to a global equity fund (the growth asset) and a euro government bond fund; however, investors have begun to recognise the diversification benefits from including other asset classes within both growth and monetary assets.

In the pursuit of higher returns, some investors allow the allocation to vary around the strategic asset allocation in an active manner. Under this approach, investors seek mispricing between asset classes to help enhance investment returns. While there are merits to this approach, it can be fraught with dangers as it is tough to get these active decisions correct on a consistent basis. Even some seasoned professionals slipped up during the COVID-19 pandemic, seeking to sell out of growth assets as the market hit the bottom based on research that indicated markets could go lower.

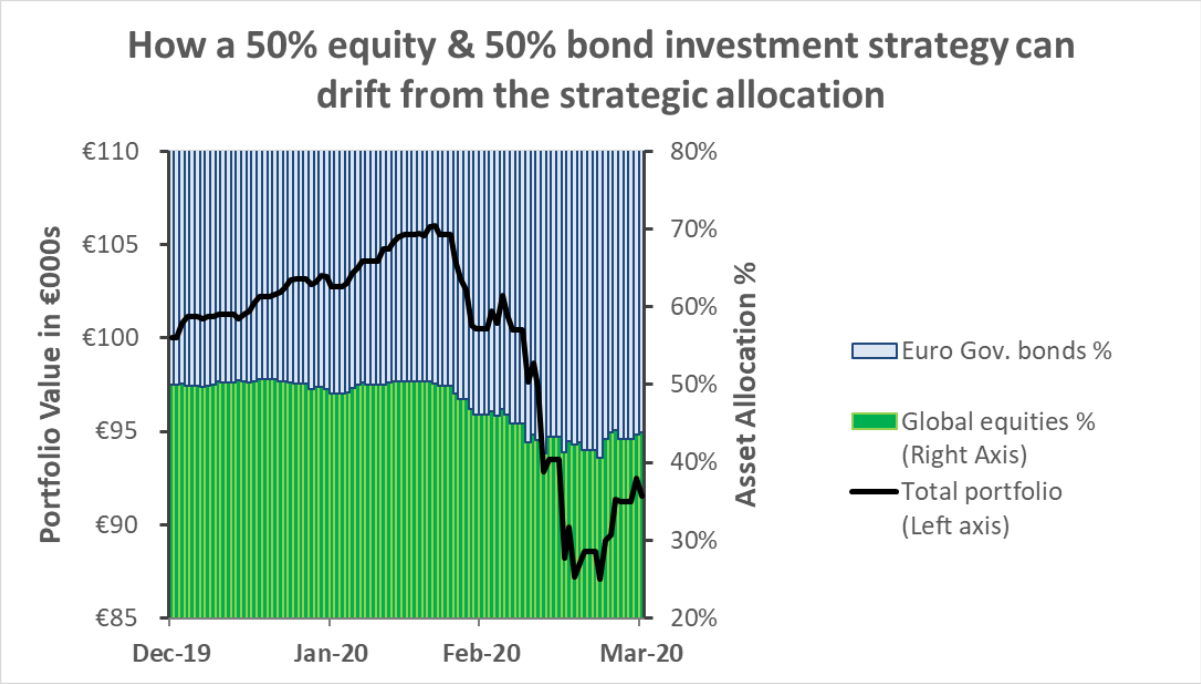
STEP 3 – ASSESS WHETHER YOUR STRATEGY CONTINUES TO MEET ITS OBJECTIVES

The final step in designing an investment strategy is just as important as the first two. With good work already carried out, it is crucial to have a plan in place to evaluate and manage your investment strategy on an ongoing basis. There are two key aspects to successfully manage an investment strategy:

1. Set a rebalancing framework

Over any period, one asset class can outperform another which can lead to an investor's savings drifting away from a desired mix, and consequently the overall return/risk characteristics might not be as desired. Rebalancing is a tool used to ensure savings are invested in line with the strategic asset allocation designed. Rebalancing involves periodically buying and selling assets in a portfolio to maintain the desired mix of equities, bonds and alternatives.

Investors with a good rebalancing framework were rewarded in 2020 as the sharp sell-off in growth assets caused portfolios to significantly deviate from the strategic asset allocation. The below chart illustrates the impact on a portfolio of 50% in global equities and 50% in high grade euro government bonds at the start of the year. In the chart, you can see how the allocation to global equities drifts from 50% to nearly 40% as equities hit their low point (with the corresponding bond holdings of near 60%). Investors who rebalanced their portfolio back to 50% equity & 50% bond weighting were rewarded by extracting more returns as markets recovered following strong support measures from governments and central banks.



For investors who opt for the pre-packaged solution, rebalancing portfolios is standard practice within the industry.

2. Conduct regular reviews

It is best practice to have regular strategy reviews so you can respond to changes in the investment environment and/or in personal circumstances:

- Investment landscape changes – over time, the relative appeal of an asset class can change. Cash used to be a more attractive investment while interest rates were 3.0% back in 2007, however the current rate of -0.5% is distinctly less appealing. An investment strategy review may highlight more attractive investment opportunities that have arisen.
- Goal changes – it has been observed that as an individual's wealth increases, they may feel more comfortable accepting more risk in the pursuit of maximising investment returns as they have a bigger reserve to absorb any potential adverse events. A review may establish such an opportunity for an individual to increase their growth exposure within their guiding principles.
- Risk appetite changes – a change in personal circumstances could mean a change in investment risk could be in order. For example, a member may seek to retire earlier than planned, so dialling up the protection within the investment strategy could be in order.

The frequency of an investment strategy review depends on the circumstances. It is best practice to have an investment strategy review at least every 3 years (in many cases, more frequent reviews would be in order).

SUMMARY

This paper provided an overview of designing an investment strategy by providing a high level overview of the three step process as follows:

1. Establish what your investment objectives are
    - By reviewing the factors like your investment goals, your risk tolerance and your personal circumstances.
2. Purchase assets in line with the guiding investment principles established
    - Investors can use a pre-packaged solution or a tailor made solution. The tailor made solution is more complex with investors needing to evaluate the pros and cons of several asset classes.
    - For a tailor made investment strategy, we identified that setting a strategic asset allocation was a key tool to appropriately balance the return and risk objectives.
3. Management of your investment strategy
    1. Set a rebalancing framework – the recent sell-off in growth assets and subsequent recovery demonstrated how rebalancing framework can add value.
    2. Conduct regular reviews – as the investment landscape or personal circumstances change, it makes sense to conduct a regular strategy review to identify if improvements can be made.

Designing investment strategies is a skill we pride ourselves on at Invesco. We have honed this skill as the company has grown over the last 25 years, with expertise to meet the needs of pension schemes and individual investors. We are happy to assist in designing the right investment strategy for you if you reach out to your Invesco consultant or Richard White of our Wealth Management team at Rwhite@invesco.ie.

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