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## MANAGING YOUR MONEY

## The right equity balance

Our reader is right to hold cash, but needs to improve the diversity of the rest of his portfolio at the same time as reducing the number of holdings

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By **Chris Dillow** , Jason Hollands and David Liddell

Philip is aged 64 and he and his wife have been investing for 15 years. They were both teachers who retired in 2014. They have more than adequate income for their needs: Philip has a pension of £33,000 a year and will soon have a state pension. His wife has a pension of £12,000 a year and a £7,000 state pension, which she deferred for two years.

### Reader Portfolio

## Philip and his wife, 64

### Description

Isas and investments outside a tax wrapper

### Objectives

Cover for care and inheritance

**W**e have no mortgage on our house or on our buy-to-let property, which is worth £270,000 and produces an income of £600 a month," says Philip. "We used our lump sums to refurbish the house and have kept £80,000 cash, which seems too much. We reinvest all the dividends and aim to not touch our investments for five to 10 years, which has paid off. Reinvesting all dividends received has also made a big difference and has a similar effect to when we used to pound-cost average. We do not invest much now but like to let

our dividends do it for us.

## “ IT NEARLY ALWAYS MAKES SENSE TO HAVE SOME SORT OF RAINY DAY FUND, EVEN IF THE CURRENT LOW INTEREST RATE IS PUNISHING SAVERS ”

"We enjoy foreign holidays, especially long-distance trips. We manage to save enough to cover our housing costs. We see our investments as cover for care and some inheritance for our girls. We are not higher-rate taxpayers, and virtually all the investment trusts outside individual savings accounts (Isa) are in my wife's name.

"Our attitude to risk is high, but with good pensions, our buy-to-let property and £80,000 in cash I feel we are not being foolhardy.

"We do not hold any bonds - I was wary of switching into these because both my parents lived until they were 90 so I could have many years of life left. If not, we will not need it all. I also do not really understand bonds and it doesn't seem the best time to move a lot of money into this asset class. I work on the basis that our equity holdings in the long run will certainly outdo cash, and probably bonds. We see no urgent need to suddenly access a huge amount of money, and could always sell our buy-to-let property. The changes to dividend tax will also help us. We have also always avoided individual shares.

"We are mainly invested in developed markets. We prefer investment trusts, in particular ones focused on smaller companies, but try to be diversified across companies and markets. We probably have too many holdings but I enjoy following them.

"Over the next few years we will move our larger holdings in investment trusts into Isas. Our equity holdings have varied between £430,000 and £450,000 this year. We would be interested to know what to do with them and how much to keep in cash.

"Our last three trades were **RIT Capital Partners** (RCP)\*, **Aberdeen Asian Income** (AAIF)\* and **TR Property** (TRY)\*.

"We are looking to top up Aberdeen Asian Income and **Marlborough Multi Cap Income Fund** (GB00B908BY75)."

Holding	Value (£)	% of portfolio
<b>Holdings outside Isa</b>		
Aberdeen Asian Income Fund (AAIF)	9,100	2.1
Aberdeen Asian Smaller Companies (AAS)	8,400	1.9
Edinburgh Dragon (EFM)	2,009	0.5
Aberdeen New Dawn (ABD)	1,961	0.5

North American Income Trust (NAIT)	5,616	1.3
BlackRock Latin American (BRLA)	915	0.2
BlackRock World Mining Trust (BRWM)	2,870	0.7
Caledonia (CLDN)	4,700	1.1
F&C Global Smaller Companies (FCS)	14,900	3.4
TR Property (TRY)	15,000	3.4

## THE BIG PICTURE

### Chris Dillow, Investors Chronicle's economist, says:

You are not being foolhardy in holding lots of equities and no bonds. As **Javier Estrada** of IESE Business School and Narayana Kocherlakota, president of the Federal Reserve Bank of Minneapolis, have shown in different ways, the idea that people should own fewer shares as they get older is an old wives' tale. The fact that you have a decent income from other sources and hold a lot of cash means that you don't need bonds.

But equities are not guaranteed to outperform cash or bonds over the long term. Let's take a reasonable working assumption that shares would average an annual real return of 5 per cent with a standard deviation of 20 percentage points, and that cash has a zero real return. On this basis, there's around a one in 11 chance that shares will underperform cash even over a 10-year period.

And recent history suggests this might be too optimistic. UK shares have actually underperformed bonds since 1998, while even since the late 1980s they have only outperformed them by around 1 per cent a year. The equity premium might be smaller than you think.

So there is a case for holding at least some of that cash. How much depends on factors including how fearful you are about needing lots of care in later life, and how worried you are about the possibility that your daughters' inheritances will be less than what you or they might expect.

### David Liddell, chief executive, IpsosFacto Investor, says:

Including your buy-to-let and cash, but excluding your home, you have roughly 54 per cent in a well-diversified portfolio of equities, 35 per cent in property and 11 per cent in cash. You think the cash allocation may be too much, but I am not sure it necessarily is. Although your income needs are taken care of by your pensions it nearly always make sense to have some sort of rainy day fund, even if the current low interest rate is punishing savers, and if you are steering clear of bonds then cash may be the best diversifier for your equity and property holdings.

One of the keys to building wealth is not having to sell out at a bad time, so having a cash cushion is important. A recession or high interest rates which might affect your equity portfolio negatively would probably also adversely affect your buy-to-let property. I understand why at current valuations you have no bonds, but it is something you might like to review if their yields become more attractive. High-quality government bonds can be a good diversifier and a source of liquidity, and be used to match against future liabilities. In the meantime, keeping a reasonably high cash allocation makes sense.

With equity holdings that have done well you could keep the dividends in cash rather than reinvesting, but for the weaker performing assets over recent times, such as those focused on Asia, it certainly makes sense to keep reinvesting.

Although you say you are below the £5,000 level of dividend income at which tax starts to be charged, the yield on the non-Isa investment trust portfolio is about 2.1 per cent, or £4,700, which is mainly in your wife's name. And if the non-Isa holdings are showing good gains, you may want to make sure that you both are making use of your annual capital gains tax (CGT) allowance of £11,100. It could be a good strategy to transfer some of the investments your wife holds to you to maximise your CGT exemptions.

You and your wife should also maximise your Isa contributions for each tax year as you say you intend to do, so the dividend income is not taxed and you have increased flexibility to realise your investments without worrying about CGT.

## HOW TO IMPROVE THE PORTFOLIO

### Chris Dillow says:

Your portfolio is less diversified than you think. Your good returns should alert you to this: high returns can be a sign that you're taking on lots of risk.

The problem is simple: as a fund adds shares to its holdings the importance of any individual stock's idiosyncratic risk declines. But systematic risk - the sort of thing that causes stocks to fall together - increases. This means that funds will be correlated with the general global equity market. Because of this, they'll be correlated with each other. For example, if we look at annual price changes since 2000, the correlation between **F&C Global Smaller Companies** (FCS)\* and RIT Capital is 0.78, and between **F&C Global Smaller Companies** and **JPMorgan US Smaller Companies** (JUSC)\* it is also 0.78. This means that bad times for one are highly likely to be bad times for the others.

This means an apparently well-diversified portfolio of funds such as yours is, to a large extent, a global index

tracker.

The problem is that your near-tracker comes at a higher cost than it could, because of the fees charged by active fund managers. You should consider whether these funds are giving you anything your other funds aren't. With **Artemis Income** (GB00B2PLJJ36) and **JOHCM UK Equity Income** (GB00B95FCK64), this might be the case: they give you exposure to UK defensives. But I'm not sure the same can be said of the others.

Try not to add unnecessary charges.

**Jason Hollands, managing director, Tilney Bestinvest, says:**

You show little evidence of an asset allocation strategy, with poor diversification across asset classes - your portfolio is about 97 per cent invested in equities.

You say you have a high risk appetite, and that your income needs are covered by pensions and a rental property. But even aggressive portfolios include other assets. Although equities should remain the primary asset class for long-term investors, for nearly eight years these have been abnormally boosted by money printing and ultra-low interest rates. The withdrawal of this liquidity at a time when global growth is slowing means equities may struggle to deliver the returns we have been used to, so it might be wise to add some diversification to protect your gains.

Bond markets have also been severely distorted by the stimulus measures, so could also be vulnerable as the measures unwind. Instead consider absolute return and property funds which invest in actual buildings, as these should help reduce overall volatility.

**Invesco Perpetual Global Targeted Returns Fund** (GB00BJ04HL49) aims for a gross return of 5 per cent more than three-month Libor with less than half the volatility of global equities. The largest fund in this space, **Standard Life Global Absolute Return Strategies** (GB00B7K3T226)\*, has a similar strategy.

Physical commercial property - ownership of buildings such as offices, shopping centres and warehouses - can also aid diversity and should not be confused with residential property. Many property investment trusts are trading at quite large premiums to net asset value (NAV) but **Picton Property Income** (PCTN)\*, which pays quarterly dividends and yields 4.6 per cent, is trading close to NAV.

You lack exposure to Japan, a major equity market that should be on investors' radars because its monetary policy remains highly supportive of its stock market, the massive Japanese Government Pension Fund is targeting much higher equity allocations, and improving corporate governance at Japanese companies has resulted in a marked increase in dividend payments and share buybacks. You have just 0.7 per cent exposure to Japan indirectly through some of your global funds, but could consider 7 to 8 per cent exposure.

A core holding could be **Schroder Tokyo** (GB00B4SZR818)\*, but recently listed **CC Japan Income & Growth Trust** (CCJI) also looks attractive. Its managers have an excellent record with their offshore funds and are building a portfolio of companies for the trust with strong dividend prospects.

Your large weighting to Europe is sensible as interest rate and stimulus policy here also remains very supportive to equities. The US is starting to tighten the noose, so I would reduce exposure there to maybe 10 per cent. The US market is expensive compared with history, earnings growth is slowing and rising interest rates could slow the trend of companies borrowing money cheaply to buy back their shares. **North American Income** (NAIT) hasn't been great so could be redeployed into absolute return or property funds.

You are overdiversified in terms of number of holdings - professional fund investors typically hold no more than 20. Capping the number is good self-discipline as when you are tempted to invest in something new you have to think about what you need to ditch, forcing you to appraise whether you still have conviction in what you own.

The holdings in multiple Asian investments managed by the same team at Aberdeen are not performing as well as they used to, and what's the point in holding so many funds managed by the same people? Why not consolidate these into **Stewart Investors Asia Pacific Leaders** (GB0033874768)\* and some Japan funds?

The outlook for commodities remains dreadful and Latin America, which is dominated by Brazil, is a basket case. You could switch your Latin American exposure into a more general emerging markets fund such as **JPMorgan Emerging Markets** (JMG).

**David Liddell says:**

RIT Capital is standing at a premium to NAV of 5 per cent, so now could be a good time to take some profits and reduce it a little.

Your portfolio has good geographic diversification but you don't have much exposure to Japan. You might like to consider the consistently strong performer **Baillie Gifford Japan** (BGFD)\* or as this trust is trading at a premium, an exchange-traded fund (ETF) such as **Vanguard FTSE Japan ETF** (VJPN)\*\*.

\*IC Top 100 Fund

\*\*IC Top 50 ETF