



Our investment philosophy and research methodology

Updated April 2013

About this document

This document is designed to give existing and prospective clients an insight into how and why we undertake our investment research. Where possible, we have kept the information to a minimum so that we do not overburden you with too much technical detail.

This document should help you to read our Investment Management reports, which will be an important part of our review process.

Our investment philosophy

We firmly believe that it is important for you to understand how and why we work in the way that we do. This will give you confidence that we operate a robust process in which investment decisions can be made. We act in the same way for all clients, although we can offer a bespoke approach where required. This is so that we consistently apply the research and theory in a manner that can help you to achieve the best results for your circumstances.

Understanding your investments

We firmly believe that if you do not understand a product or the reasons for it, then you should not invest in it. We believe that we should keep things as simple as possible without good reason. In our experience, most complex financial products are created to help the adviser to make a sale rather than to look after your interests. Therefore, we want to help educate you in the investment process.

Process

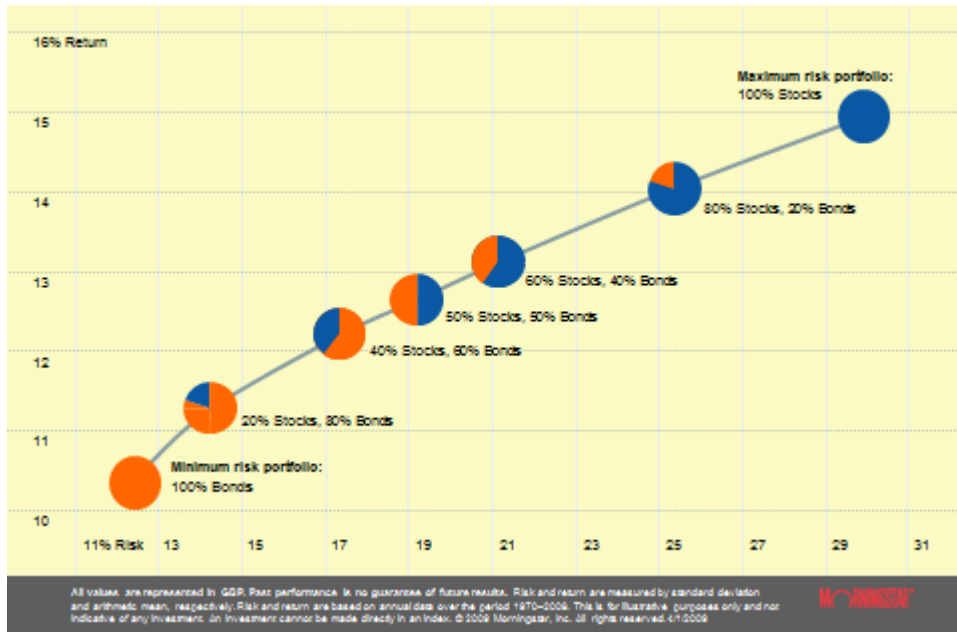
We believe that without a considered and repeatable investment process you will not be able to get the best out of your investments. Many investors fail because they do not apply a consistent approach to their investing. We help you to take a step back and analyse the best way forward, and to hopefully remove the emotion from the situation; this should help you to avoid costly errors.

You can find out more about our investment research process below.

Risk

Investment management is all about managing risk. All investments involve some sort of risk, from almost no risk, to a high level of risk. In general terms it can be said that the greater the risk you take the greater returns you should generate on average over time; the reverse is also true. Therefore, over time you should expect low risk and low returns on assets such as cash or bank accounts (perhaps below inflation), and greater risk and greater returns on riskier assets such as shares.

Stocks and Bonds: Risk Versus Return 1970–2008



The above chart shows example simple portfolios on the efficient frontier. As the risks taken increase, so do the returns over time, although greater volatility comes with this.

We focus on 2 important measures of risk.

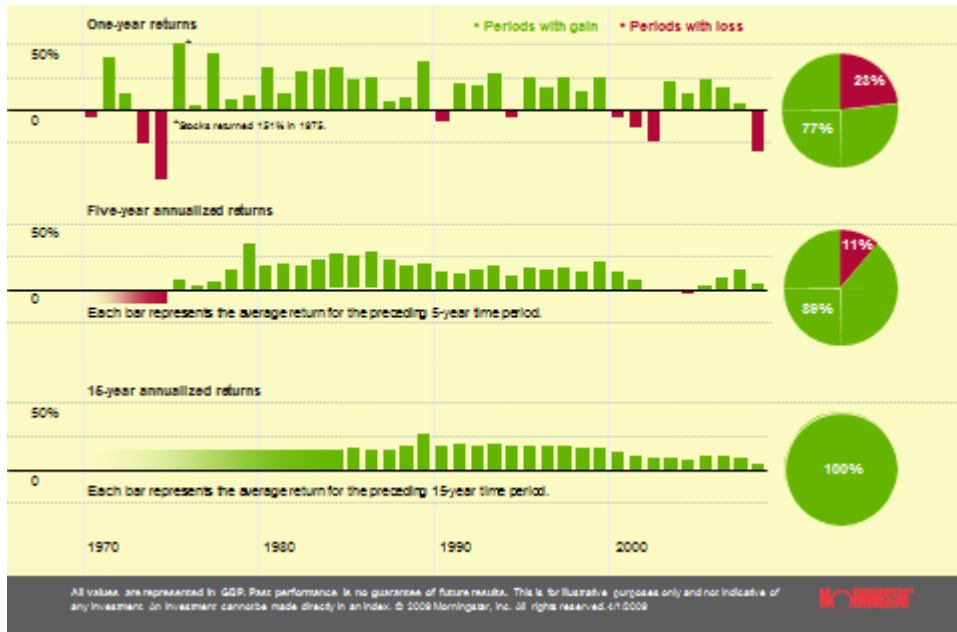
How much risk can you bear?

Think of it as a how much risk you can bear before you lie awake at night worrying about your decisions. Your risk appetite is probably shaped by your investment experience and expertise. Once we know and quantify this, we are in a better position to help you to choose investments which do not take too much risk.

How much risk you need to take

This is an important distinction, since you might place your tolerance for risk differently to what you actually need to take to achieve your goals. If you describe your risk profile as moderate, but you only need to take cautious risks to achieve your goals, then why take the extra risk? If you do not need to take risk, then why do it? Of course, the reverse is also true – some cautious investors should consider taking extra risks to achieve their goals.

Risk of Stock Market Loss Over Time 1970–2008



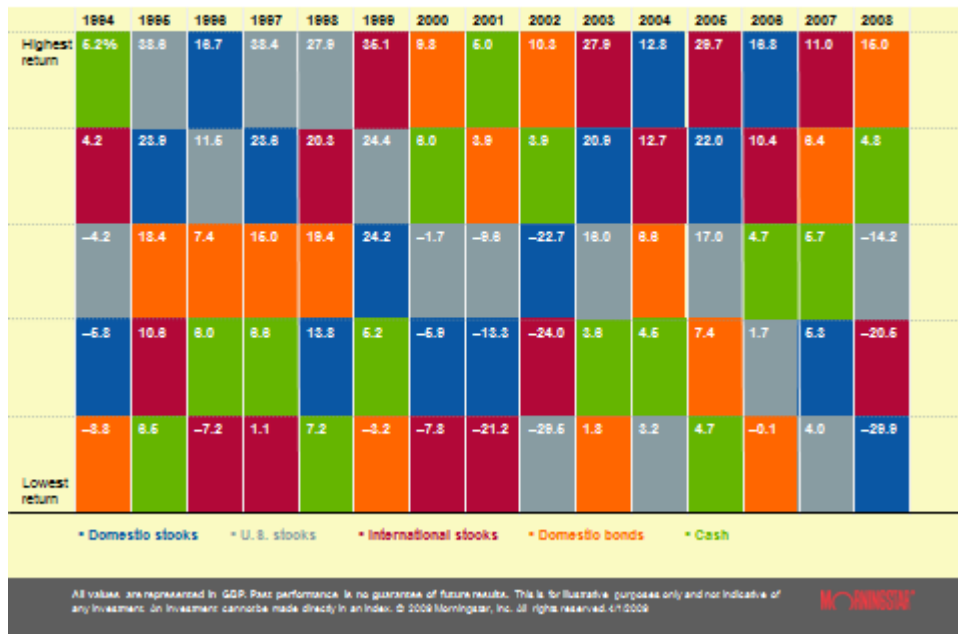
The above chart shows how likely you would have been to lose money if you had invested in the stock market in the past. This shows that the longer you invest, the less likely you are to lose money.

Diversification

The best way to manage risks is to diversify your portfolio. This can be in a number of ways such as increasing the number of holdings. For example, if you hold 1 company in your portfolio and this fails, then you lose 100% of your investment. If you hold 50 companies equally, and 1 fails, you only lose 2%.

This concept can extend to different types of asset (split between cash, fixed interest, shares and property), different geographical locations, and currencies. In theory, the wider you diversify the smoother your returns. Research has shown that this approach limits the downside of your portfolio without too much impact on the upside.

Asset-Class Winners and Losers 1994–2008



It is impossible to pick which asset class will be the best or worst performing in any given year, as this chart shows.

Asset allocation

Portfolio construction generally starts with asset allocation. This is the choice of which assets to use, and in what proportion. This will be put together with a medium to long term view, and have a combination of assets that will work together to deliver the risks and returns you want. Various academic research papers have analysed investment portfolios and have concluded that the majority of a portfolio's performance over time can be attributed to this part of the process.

We take your risk profile and use this to determine your ideal investment mix using portfolios designed by Ibbotson Associates, Ibbotson Associates are worldwide leaders in portfolio theory, and have designed portfolios to match the risks you expect to take with your money. We then use our investment research process (below) to allocate a suitable mix of investment funds to match your individual needs.

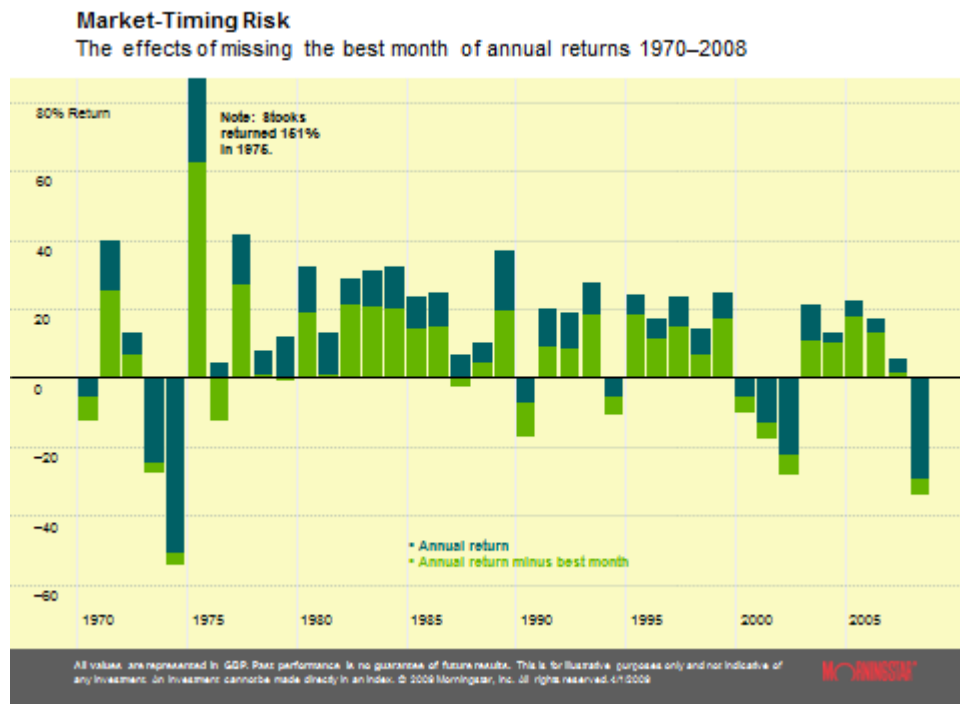
Rebalancing your portfolio

Naturally, each of the assets contained in your portfolio will perform in a different manner. As such, over time, better performing assets will form a larger proportion of your portfolio, and therefore alter the risk of your portfolio. To minimise the risks of this happening, at future reviews we will make recommendations to switch funds back towards the ideal asset allocation.

Market timing

It can be tempting to try and make short term gains on portfolios by moving in and out of the different markets. Even with very strong market and economic data, this is almost impossible to get right every time. For this reason, portfolios should be put together on the basis of delivering longer term performance rather than taking active short term bets. We try not to guess the market, as

even fund managers get this wrong, with far more detailed data than we possess. Instead, we focus on delivering stable returns over the medium to long-term using the principles outlined above.

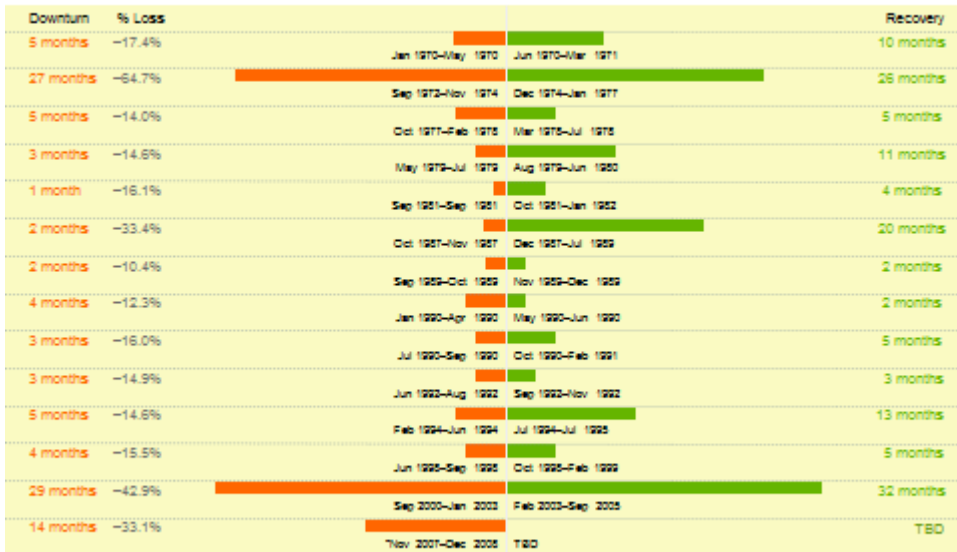


The above chart shows the effect of missing the best month of returns going back to 1970. Missing the best month drastically reduced returns, and in 3 year actually turned a positive year into a negative return.

Market turbulence

In turbulent stock market periods it can be tempting to reduce the risk of your portfolio by biasing the portfolio more towards safer assets. However, in doing this, all that is really being achieved is to hamper future performance in the longer term, or even to lock in losses. The best thing to do is to trust in the process of the portfolio and markets, so that you can benefit from any recovery in the market. A big stock market fall in one period is usually followed by a big gain afterwards. These periods of turbulence are less important over time.

Market Downturns and Recoveries 1970–2008



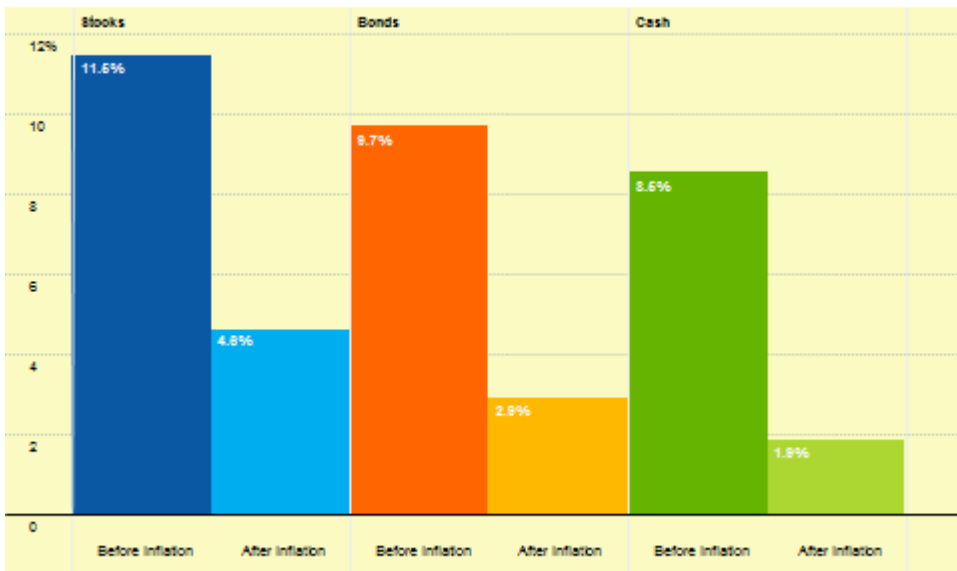
All values are represented in GDP. Past performance is no guarantee of future results. *The exact length of the downturn has yet to be determined. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an Index. © 2009 Morningstar, Inc. All rights reserved. 4/10/09



Inflation

Inflation has an underestimated impact on returns over time. Often people focus on the actual rates of return without reflecting on the impact of the increase in the cost of living.

Returns Before and After Inflation 1970–2008



All values are represented in GDP. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an Index. © 2009 Morningstar, Inc. All rights reserved. 4/10/09



The above chart shows how returns can be adversely affected by inflation. While inflation is currently lower than historical averages, cash savings are currently losing money in real terms.

Active or passive funds

We recognise that there are positive reasons for investing in actively managed funds as well as passive index-trackers (which tend to be cheaper). We do not have a particular bias, and prefer a statistical analysis of a fund to guide our decisions. In our experience, many advocates of passive strategies do so in order to boost their own fees.

Investment research process

Research systems

In our experience many investment advisers and firms do not use a defined research process to guide their investment recommendations. Many simply use the free insurance company factsheets which are available. In our view, this compromises their independence, and does not allow for a thorough examination of the investment market. Worse, many firms do not even share the same investment process, and the approach taken will differ between advisers.

We use a complex and sophisticated investment management tool, called Morningstar Adviser Workstation. This allows us to examine every investment vehicle on the market, and includes an amazing amount of data points for us to use. This allows us to research on your behalf free from the marketing messages pushed at us from investment companies, and actually base our recommendations on results rather than anything else. This system is not cheap to run, but without it we would not be able to provide you with a robust investment service.

How we conduct our investment research

Our investment process examines all the funds available through your selected contract and analyses which funds would be appropriate for your needs, based on the ideal portfolio mix for your risk profile.

We start by sifting funds which can demonstrate superior Morningstar ratings, and above average past performance. Following this, we rank funds according to the other criteria set out below. This enables us to identify funds which are consistently performing well. We are looking for funds which can demonstrate a consistent performance history, which do not take too much risk to achieve this, and do not charge too much. When all these aspects are put together, we believe that the cream will rise to the top.

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Annualised return for 1, 3 & 5 years

We rank the fund according to their actual past performance. Returns for periods longer than one year are expressed as annualised returns. This is equivalent to the compound rate of return which, over a certain period of time, would produce a fund's total return over that same period.

Morningstar rating

The Morningstar Rating for funds, commonly called the star rating, is a measure of a fund's risk-adjusted return, relative to similar funds. Funds are rated from one to five stars, with the best performers receiving five stars and the worst performers receiving as single star.

Risk-adjusted return is calculated by subtracting a risk penalty from each fund total return, after accounting for all loads, sales charges, and redemption fees. The risk penalty is determined by the amount of variation in the fund's monthly return, with emphasis on downward variation. The greater the variation, the larger the penalty. Funds are ranked within their categories and stars are assigned as follows:

- Top 10%: 5 stars
- Next 22.5%: 4 stars
- Middle 35%: 3 stars
- Next 22.5%: 2 stars
- Bottom 10%: 1 star

Standard Deviation (volatility)

Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely an investment's returns varied over a certain period of time. We use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility.

This is useful for us to compare volatility and therefore risk in your portfolio.

Beta ratio

We use beta to measure a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. We calculate beta by comparing a fund's excess return over short term gilts to the market's excess return over short term gilts. A beta of 1.10 shows that the fund has performed 10% better than its benchmark index in up markets and 10% worse in down markets, assuming all other factors remain constant. Conversely, a beta of 0.85 indicates that the fund's excess return is expected to perform 15% worse than the market's excess return during up markets and 15% better during down markets.

This is useful for us to measure how much your portfolio simply mirrors market movements, and the expected divergence of returns over time.

Alpha ratio

Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive alpha figure indicates the portfolio has performed better than its beta would predict. In contrast, a negative alpha indicates the portfolio has underperformed, given the expectations established by beta.

We use alpha to assess whether an investment appears to add value compared to its peers. If it does not add value, there would seem little point in investing in a fund which will also drag returns through charges.

Sharpe ratio

The Sharpe Ratio is a risk-adjusted measure developed by Nobel Laureate William Sharpe. It is calculated by using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the portfolio's historical risk-adjusted performance.

It can be used to compare two portfolios directly on how much excess return each portfolio achieved for a certain level of risk. This is important when assessing whether your portfolio meets the risk limits put on it. We would not wish to generate high returns along with excess risk unless this is what you actually want.

Information ratio

Information ratio is another risk-adjusted performance measure. The information ratio is a special version of the Sharpe Ratio in that the benchmark does not have to be the risk-free rate. This rating shows the consistency of your fund compared against the market. The higher the ratio, the more consistent the fund.

Ultimately, we look for consistent performers over time to hopefully aim for more stable returns in your portfolio.

Charges

We also examine the charges of the individual fund, as this will have an impact on the performance. We use the Total Expense Ratio, which measures all charges, explicit and otherwise, since some fund charges are not openly declared.

Turnover ratio

This is a measure of the fund's trading activity. In practical terms, the resulting percentage loosely represents the percentage of the portfolio's holdings that have changed over the past year.

This is useful to assess whether hidden transaction costs are likely to have an impact on the charges of the investment, thus creating a drag on performance.



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