DIVERSIFICATION IN MULTI-ASSET FUNDS

AN INTRODUCTION

SCOTTISH WIDOWS

MULTI-ASSET FUNDS

The term ‘multi-asset funds’ refers to funds which invest in several asset classes, from the traditional equities (shares), bonds, property and cash to the more recent introduction of absolute return and commodities.

WHY

Multi-asset funds invest your money in assets which tend to have different performance characteristics. This increases the diversification of the fund, which means you’re not as exposed to the market gains and losses of just one asset class. Multi-asset managers are creating the potential for capital growth and the conditions in which the better performers may offset the poorer performers.

HOW

Many factors affect the performance of an investment: economic health, interest rates, investor sentiment and world events, to name but a few. While changes in some of these factors may be harmful to the performance of one asset type, say equities, in contrast they may support the performance of another asset type, say government bonds (gilts). Asset classes tend to perform in a different way over different time periods.

The table below shows how different asset classes have performed (the returns they’ve produced) over different time periods. You can see that sometimes they’ve performed well and sometimes they haven’t – on a year-to-year basis the returns of any one asset class can vary considerably.

By combining several types of assets in one fund, multi-asset managers seek to reduce volatility by offsetting the falls of one asset class with the potential gains of another.

The value of an investment is not guaranteed and can go up and down depending on investment performance (and currency exchange rates where a fund invests overseas). You may not get back the amount you originally invested.

Please remember that past performance is not a reliable indicator of future results.

ASSET CLASS RETURNS OVER THE LONG TERM

Asset class	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Overseas Equities	-4.06	-14.04	-27.35	20.66	7.83	24.85	5.65	9.70	-17.12	18.86	16.69	-6.12	11.95	22.69	12.26	4.77
UK Equities	-5.90	-13.29	-22.68	20.86	12.84	22.04	16.75	5.32	-29.93	30.12	14.51	-3.46	12.30	20.81	1.18	0.98
UK Property	10.51	7.06	10.45	11.24	18.89	18.83	18.12	-5.47	-22.53	2.18	14.49	8.09	2.35	10.90	19.31	13.82
UK Gilts	8.99	3.08	9.47	2.09	6.61	8.00	0.50	4.70	13.59	-0.81	7.26	16.90	2.73	-4.09	14.92	0.45
Commodities	61.56	-30.14	19.39	8.56	9.35	40.41	-25.52	30.44	-25.91	1.04	12.45	-0.44	-4.32	-3.05	-28.90	-28.97
Cash	6.28	5.10	4.11	3.76	4.70	4.85	4.91	6.08	5.82	1.31	0.69	0.86	0.85	0.51	0.54	0.57

Key:

BEST PERFORMING	2ND BEST PERFORMING	3RD BEST PERFORMING	4TH BEST PERFORMING	5TH BEST PERFORMING	WORST PERFORMING

Sources:

Overseas Equities	FTSE World ex UK Index
UK Equities	FTSE All Share Index
UK Property	IPD UK All Property Monthly
UK Gilts	Citigroup United Kingdom WGBI
Commodities	S&P GSCI Commodity Index
Cash	3 Month LIBID (London Interbank Bid Rate – the rate at which major London banks borrow deposits from other banks in a currency different to their home currency)

Source: Financial Express, total return in sterling terms. Performance is measured from 1 January to 31 December each year. Past performance is not a reliable indicator of future results.

DEMYSTIFYING DIVERSIFICATION

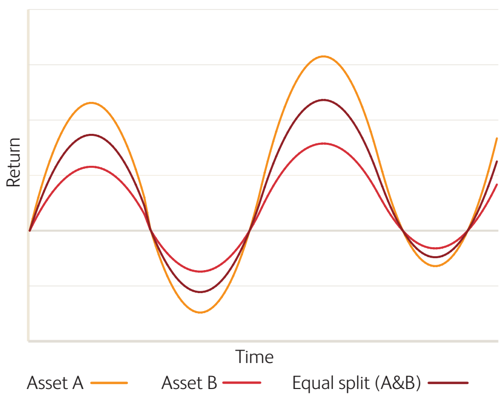
Diversification is at the heart of successful multi-asset investing. Some people may refer to diversification as what we describe above: holding a variety of different investments. But there's more to it than just investing in a random assortment of assets.

Effective diversification means looking at the behaviour of asset classes and selecting those that are thought to perform differently in any particular set of market conditions.

In chart 1 below you can see two sample assets which behave in a similar manner. They are moving up and down at the same points but not to exactly the same extent – overall, the market conditions are affecting them in the same way. If you invested 50% in asset A and 50% in asset B, you would achieve the middle ground as illustrated – an average of both assets' returns and both assets' risk.

Assets behaving in the same way

Chart 1



Source: Scottish Widows. For illustrative purposes only.

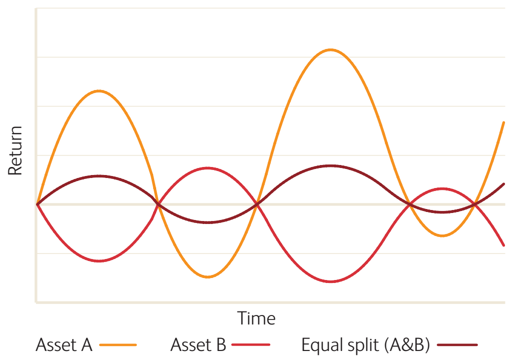
NOW FOR THE CLEVER BIT

In chart 2, the picture is very different if you invest in two assets which behave in exactly the opposite way. As you'll see in chart 2, when asset A goes up, asset B goes down – when the market conditions are positive for one they are negative for the other and vice versa. In this case, if you invested 50% in both assets your return would still be an average of both asset classes.

However, as you'll see from chart 2, the peaks of one asset cancel out the troughs of the other giving a much smoother performance – and less risk. In this case, this means that by holding assets that are affected by the market in different ways you can achieve a lower risk than investing in any one of these particular assets individually. However, this could reduce the growth potential.

Assets performing in opposite ways

Chart 2



Source: Scottish Widows. For illustrative purposes only.

What we've shown you is two extremes. The degree of diversification will depend on the assets you hold. If they are all similarly affected by market conditions, the diversification impact is minimal but if they react in different ways to market conditions, then you could see the real benefits of diversification. Remember, just because the individual funds are risky doesn't necessarily mean that when you invest in them together it makes it more or less risky. It all depends on how the assets in the fund behave in relation to one another.

IN SUMMARY

All of the above is known as diversification. Put simply, diversification is about aiming to get the best return for the least amount of risk.

Diversification isn't a new strategy; managed funds have been using it for many years, traditionally by mixing equities, bonds and property. Today's investment manager is increasingly looking to alternative assets which move in a different way to traditional ones, such as commodities and derivatives, to diversify funds even further.

The value of a multi-asset fund will depend on the combined performance of all the assets held by it. **A rise in the value of one asset class may not result in an increase in the fund's value.** Similarly, a fall in the value of one asset class may not result in a fall in the value of the fund if others have risen by more.

If you have any questions about diversification, please contact your financial adviser. Please note, there may be a charge for this.

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