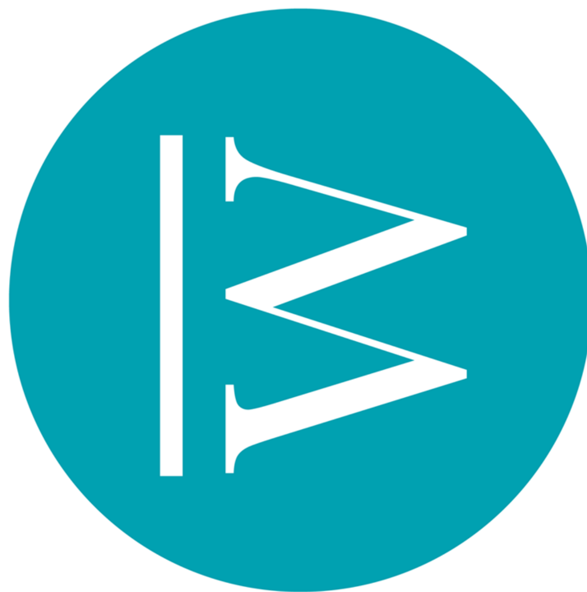
Investment Process & Procedures Manual

Bellwether Financial Planning



1. Introduction

Investing is inevitably an emotional endeavour. Unless schooled in the principles of behavioural finance, most investors will at certain points unwittingly undermine portfolio returns through actions that make no rational sense albeit make perfect emotional sense.

Our goal as an adviser is to improve upon the return shortfall that investors generally experience, by means of a disciplined and structured approach to investing, which includes the following steps:

- Thorough risk profiling
- Asset allocation
- Fund selection
- Annual monitoring

This document outlines our approach to each of these critically important areas of portfolio management. Before detailing the investment process at Bellwether Financial Planning, it is important to outline the investment principles which guide our thinking and beliefs about investing.

All of our investment activities operate according to the unifying philosophy that follows.

2. Investment Philosophy

The Primacy of Risk Control

Superior investment performance is not our primary goal, but rather superior performance with less-than-commensurate risk. The emphasis at our firm is on consistency and protection and less on one-off high returns.

The Importance of Market Inefficiency

Between two-thirds and three quarters of money managers fail to beat their benchmark over the long run. We believe less efficient markets exist in which dispassionate application of skill and effort should pay off for our

clients. As such we recommend both a passive and active approach for a portfolio.

Avoidance of Market Timing

Because we do not believe in the predictive ability required to correctly time markets, we structure portfolios with a long term time horizon in mind.

Disciplined and Structured Approach

The basis for the Bellwether's philosophy is that investors overreact in the short term due to emotional stress or excessive optimism. If investors follow a structured and disciplined approach to investing they will avoid many of the biases which cause them to act in irrational ways. Bellwether's role is to guide clients through this process.

3. Risk Profiling

Academics define investment "risk" as the volatility of returns, i.e. the extent to which the returns tend to fluctuate. The volatility number is simply an expression of the uncertainty about the size of changes in a fund's value; Higher volatility - values can potentially be spread out over a larger range. Low volatility - values do not fluctuate dramatically.

However, clients' perception of risk and what the financial services industry considers to be risk can differ entirely. This can lead to confusion if one were to rely solely on quantitative measures of risk, such as volatility.

Clients, in our experience, do not think of risk in terms of narrow mathematical terms. Clients are primarily concerned about a loss of capital or paltry returns, not necessarily price fluctuation. Clearly we cannot ignore the volatility of returns, but risk preferences need to be assessed under a broader canvas than one which focuses mainly on volatility.

Measuring Risk and Risk Tolerance

Given the aforementioned problems with measuring risk, where does Bellwether start? Just as risk is not a single number, neither is a client's risk profile. This is difficult to measure accurately.

Our approach to risk profiling is to ask the client, in the first instance, to fill out our risk questionnaire.

The questionnaire should only provide a starting point for a conversation about investment risk, not an ending. We use the output of this tool to form the basis of a broad discussion on risk which is also examined in Bellwether's Financial Planning Review document.

A client's psychological willingness to take risk can sometimes clash with their financial ability to do so. For example, a client might express a preference for risk which is low, but have a financial situation which indicates a risk capacity which is higher. When such a conflict exists, we take time to counsel the client and explain the consequences of the mismatch.

Ultimately, a client might insist on an investment strategy that does not match their risk attitude and we may need to accept this. But having had the conversation, the client/adviser decision will at least be in the context of a thorough review of the investor's risk capacity, attitude and need.

Risk Profile Questionnaire

A client's 'willingness' to take risk, as measured by a questionnaire for example, is only a small part of a client's full and true risk profile.

Three key components comprise an individual's true risk profile:

- Psychological willingness to take risk, sometimes called 'risk attitude' or 'risk preference'
- Financial ability to take risk, or 'risk capacity'
- Need to take risk, including the need to accept risk to meet an objective, avoid falling short of a goal or having wealth eroded by inflation.

ORRA Risk Questionnaire

Bellwether use ORRA's risk questionnaire. ORRA are an independent company, linked to Oxford University. They are leading experts in the field of risk analysis, dedicated to the practical application of knowledge in risk and risk behaviour. They have vast experience of creating risk and decision-making solutions in a diverse range of commercial industries including insurance and the government. ORRA have used the latest techniques from

mathematical modelling and the expertise of world-class scientists to produce a robust, effective and unique risk questionnaire.

4. Asset Allocation

Having established what the client's objectives are and agreed an appropriate level of risk commensurate with the goals and attitudes, it is important to then translate this into an appropriate investment strategy.

Empirical studies demonstrate that the vast majority of investment returns can be attributed to the asset allocation decision. The results of these studies are often misinterpreted, but consistent through the analysis is the observation that active investment decisions such as market-timing and/or security selection have a more modest impact and, on average, reduce portfolio return.

Clearly, an investment approach based upon investment across multiple asset classes is not a proprietary strategy. It is an approach recommended the world over, but one which is followed with indifference.

Bellwether's investment recommendation will maintain an active asset allocation strategy, as distinct from a tactical asset allocation strategy. There will be a strategic allocation to a selection of diverse asset classes. No assessment is made about the likely short term performance of any of these asset classes and no short term changes (tactical) to the asset allocation will be made in an effort to add value.

5. Fund Selection Process

Investment Philosophy and Fund Selection

Notwithstanding the fact that asset allocation is the main driver for the returns of a portfolio, the selection of appropriate investment vehicles within each asset class is an important step in the investment process.

Consistent with our investment philosophy, and in recognition of the inability of active managers to consistently outperform, we recommend investment through passive investments for a large portion of a portfolio.

We do, however, also recognise the efficacy of an active approach to fund management. In less efficient areas of the market, or where a viable passive

alternative does not exist (e.g. absolute return, property), then active management is considered appropriate.

6. Portfolio Monitoring

The ability to harvest gains as investments are going up, and at the same time invest in asset classes as they are out of favour is a very valuable discipline. Many investors fail to benefit from diversification, owing to a lack of discipline with respect to re-balancing. Clearly, diversification does not assure a profit or protect against a loss, but it limits the damage inflicted by large downside events.

Appendix: Explanation of Investment Risk

Using standard deviation (volatility) as the measure of risk assumes that the risk of an investment is exactly the same for everyone, and that it should be measured in the same way. In reality we all perceive risks differently: what seems a risky investment to one person may seem quite acceptable to another.

Considering risk as a concept, rather than a simple number, we begin to get a better sense of what the pertinent issues are for making investment decisions. As such, below is an outline of the various types of risk an investor should consider, with a broader description contained below.

- Shortfall risk.
- Inflation risk.
- Drawdown risk.
- Liquidity risk.
- Leverage/ gearing risk.
- Credit/ counterparty risk.
- Currency risk.
- Manager risk.

It is important that clients of Bellwether are familiar with these risks. **ALL INVESTMENT FUNDS ARE HIGH RISK IF MISUSED. IT IS OUR JOB TO MAKE SURE THAT OUR CLIENTS HAVE APPROPRIATE EXPECTATIONS ABOUT RISK AND RETURN, SUCH THAT WE CAN MAP THE APPROPRIATE PORTFOLIO RISK TO EACH CLIENT.**

It does not make sense to avoid risk, unless a client can afford to. Taking risk when appropriately paid to do so is our aim.

Risk and Reward

Risk is inextricably linked to reward. In general, though not always the case, greater potential for reward comes normally at the expense of greater risk of short term price variation. In order to achieve higher levels of return an investor must expose themselves to a greater risk of volatility in the short term. However, if measuring risk as not only the fluctuation in price, but

also the risk of failing to meet performance/ return expectations, then the risk return trade-off takes on a different form.

Some investors may be willing to forgo long term returns in exchange for protection against short term price variation. So long as the investor is aware that long term returns are being traded –off in this way. Other investors are willing to accept short term price variation in exchange for the potential to generate better long terms returns. A proper assessment of a client's risk preference, their risk tolerance and capacity to bear risk will determine where they stand in this trade-off.

Time Horizon

As an investor's time horizon lengthens, the greatest risks are that: the investor's assumed rate of return is not met and/or the value of the investment is eroded by inflation.

As you extend the time period over which you observe the returns of various asset classes, what you see is a reduction in the probability of negative real returns (i.e. after inflation).

As the holding period is extended, the probability of a negative return from equities diminishes. The Barclays Equity Gilt study (2013) shows that the probability of equities outperforming Gilts over a 10 year time period is 79%. The probability of outperforming cash over a 10 year time horizon is 90%.

Shortfall Risk

This refers to the risk of failing to meet a long term investment goal. This can arise for several reasons. If an investor didn't take on enough risk to generate the returns required. On the other hand, they could also be exposed to shortfall risk if they invest in too many high-risk assets causing their portfolio to lose value at the wrong time. This is a serious risk to consider. Clearly, certain assumptions about the future have to be made in terms of determining a strategy for reaching goals, which may turn out to be erroneous. But all clients have to go on is the historic experience of asset class returns.

The relationship between risks and rewards needs careful explanation to ensure that our clients understand how and why we are structuring their portfolios.

Inflation Risk

We all have a natural tendency towards thinking about money in nominal terms, i.e. without factoring in the effects of inflation. You may not see a smaller cash balance in your accounts, but you will definitely lose buying power. In other words, the amount that you can purchase with each euro slowly erodes over time.

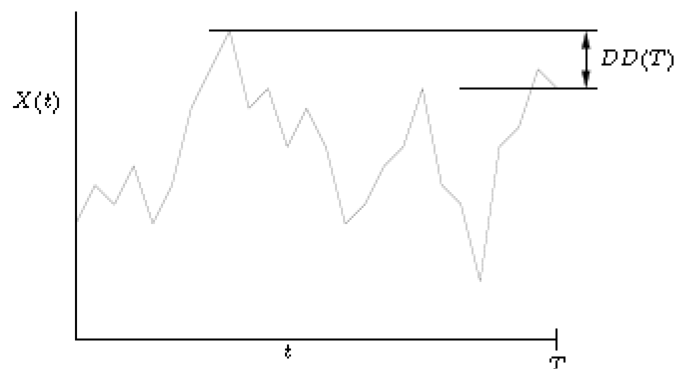
Investors need to understand that some savings vehicles fail to pay a return that beats inflation, especially after tax is deducted. The real purchasing power of your savings is what counts. It important that you don't confuse certainty and security. The certainty of cash returns does not provide security against inflation.

Inflation in the US over the very long term has averaged c. 3% p.a. Clients that ignore the risks posed by inflation, do so at their peril. 3% inflation reduces the purchasing power of a portfolio by one quarter over a ten year period.

Drawdown Risk

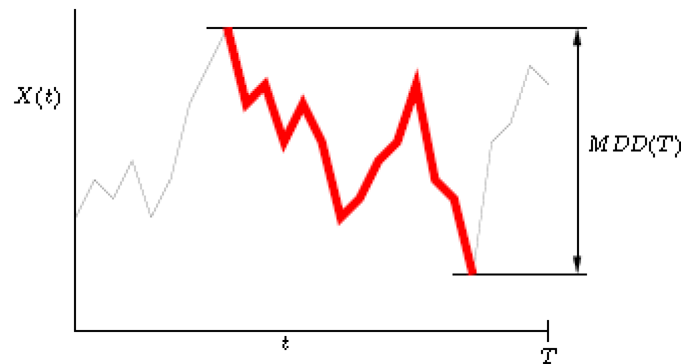
In our experience, clients don't understand volatility and cannot relate to it. When we present figures showing what an investment's experience has been using drawdown, it tends to resonate much better.

The drawdown of a fund is the loss from the peak to the current value of a fund, as shown in the chart below.



Source: "An Analysis of the Maximum Drawdown Risk Measure", Malik Magdon-Ismail (RPI) May 6, 2004.

The maximum drawdown can be loosely defined as the largest drop from a peak to a bottom in a certain time period.



Source: "An Analysis of the Maximum Drawdown Risk Measure", Malik Magdon-Ismail (RPI) May 6, 2004.

Maximum drawdown is essentially showing you what the worst experience has been if someone invested at the peak and sold at the bottom.

Other risks which are important to consider and be aware of include, though are not limited to:

<u>Liquidity Risk</u>
The risk that an investment will be difficult to buy or sell at the time you want to (and at an acceptable price) is a risk which needs to be considered. If you invest in a product with a minimum term of five years, there is considerable liquidity risk. For whatever reason, if there was a requirement to access the funds, there could be a significant penalty involved in exiting early, on top of explicit penalties that the product may charge.

Liquidity risk needs to be dealt with by always having access in a portfolio to some minimum level of cash which is available at short notice. Beyond that, then due consideration must be given to the premium being offered for foregoing short term liquidity in a product that involves limited or no access for a long period.

NB. IF YOU DECIDE TO MAINTAIN LIQUIDITY EXTERNALLY TO THE PORTFOLIO WE ARE MANAGING ON YOUR BEHALF, IT IS CRITICAL THAT YOU INCORPORATE THE PERFORMANCE OF THIS CASH, OR CASH EQUIVALENT INVESTMENT IN THE OVERALL PERFORMANCE OF YOUR PORTFOLIO. THE DECISION TO HOLD CASH, WHETHER INTERNALLY OR EXTERNALLY IS STILL AN ACTIVE INVESTMENT DECISION AND SHOULD BE CONSIDERED PART OF YOUR OVERALL PORTFOLIO FOR REPORTING PURPOSES.

Leverage/Gearing Risk

Some funds use leverage, which obviously enhances returns when the underlying asset rises more than the cost of capital. However, leverage has a particularly pernicious effect in an environment of declining asset prices, as it forces asset sales at prices which may be below intrinsic value. In this context it is related to liquidity risk. Funds that do not use leverage can generally afford to be more patient. The extent to which a fund can use leverage and the terms of its use must be considered prior to making any investment decisions. On a risk scale, a fund with leverage will appear higher up the scale owing to magnified levels of variability in its price i.e. higher volatility.

Credit or Counterparty Risk

Credit risk has entered the mainstream and is certainly one of the risks people are focused on currently. Credit risk refers more specifically to fixed interest investments and the possibility that a bond issuer will fail to repay interest and capital on time. Counterparty risk is a more general form of credit risk, relating to the inability of a counterparty to a transaction to meet their requirements. This risk appears most vividly in the form of structured products which use a counterparty for the derivative and deposit (or bond) element of the product.

Currency Risk

The risk that changes in currency exchange rates causes the value of an investment to decline. This issue is a little more complicated than it appears at face value. Many clients are concerned about the risk of the euro and the potential for a break-up of the currency union. In an attempt to address these concerns, clients are seeking diversification in non-euro currencies. What is often missed in relation to currencies, particularly where a client is invested in a diversified equity fund, is that many large European companies have an implicit currency hedge within their business.

The translational benefit of euro weakness from holding non-euro assets in a portfolio works exactly the same for companies that generate earnings outside the Eurozone. Take for example L'Oreal, a French company that generates more than half of its revenues from outside Europe. A decline in the value of the euro is boosting the foreign revenues of L'Oreal when translated back into the euro. So currency risk is not as straight forward as it may at first appear.

Manager Risk

The risk that an investment will underperform due to poor investment decisions by the Fund manager is not an inconsequential risk. Many advisers recommend the use of passive funds to avoid the issue relating to Manager Risk. Using passive funds itself involves risks also, but of a different variety.