

An introduction to portfolio construction

Creating a properly diversified portfolio is not simply a matter of building up a number of different investments. It's about understanding how different investments combine to provide an efficient portfolio, where the risk you take is adequately compensated for by the expected return. This brief guide looks at the basics of portfolio construction to provide you with a better understanding of the important steps required to meet your investment goals.

Step 1

Establish what type of investor you are

Step 2

Asset allocation

Which mix of investments do you require?

Step 3

Investment selection and diversification

Turn over the page to find out in more detail how to go about constructing an investment portfolio.

Please bear in mind that Jupiter is not in a position to offer financial advice.

Why not let an Independent Financial Adviser help?

Probably the best way to ensure that your portfolio is tailored to your needs and circumstances is to consult an Independent Financial Adviser (IFA). Once your portfolio is in place it is important to review it on an annual basis, as over the years your attitude to risk and goals may change. Through utilising the expertise of an IFA, your portfolio is more likely to stay on track and therefore succeed. If you do not currently have an IFA you can locate one in your area through IFA Promotion Ltd at www.unbiased.co.uk

Step 1: Establish what type of investor you are

The first question to ask is how much risk/volatility are you comfortable exposing yourself to? Higher long-term returns, for example, are often delivered by investments that show greater short-term volatility e.g. shares. Conversely, lower risk investments, such as bank deposit accounts, typically lead to lower returns, particularly in the long-term but your money will be more secure.

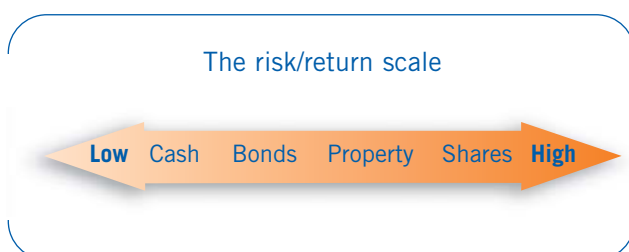
The length of time that you have to invest will also influence the risk you may be willing to take and therefore the return you will receive. For example, an individual 30 years from retirement may be willing to take on more risk for a potentially higher return, whereas an individual who retires in five years will be looking for a lower risk investment to preserve the capital that they have accumulated.

Why are you investing? If it's for a specific event such as a child's wedding or your retirement, you will have a good idea of your time horizon and of the amount of money needed at the end of the investment period. Based on the amount of money that you have to invest you can then establish how much you need your investment to return before deciding which investments are most likely to achieve this.

Step 2: Asset allocation – which mix of investments do you require?

Asset allocation revolves around determining the percentage of the four main asset classes needed in a portfolio to provide the required return at the lowest possible level of risk. In 1986 a study carried out on 91 pension funds demonstrated that the right choice of assets contributed to over 90% of long-term performance[†]. Getting it right is therefore crucial to your long-term success as an investor.

The four main asset classes



Ideally a portfolio should hold each of the four main asset classes. As different economic and market factors affect each asset class to varying degrees, they tend to move up or down independently of each other. Having some of each can help smooth out returns by lowering the portfolio's volatility. The amount of each asset held will depend on your attitude to risk, time horizon and investment goals.

What are the benefits of an asset allocation strategy?

A portfolio built up randomly over a number of years will have its own risk/reward profile i.e. it will provide a level of return for a certain level of risk. However, the return being generated may not be sufficient to compensate the investor for the level of risk he/she is exposed to. In other words, the portfolio is not as efficient as it could be.

By looking at the risk/reward profile of each asset class and understanding how they work in combination, it is possible to build a more efficient portfolio. This could allow you to either achieve the same expected return for much less risk or a greater potential return for the same level of risk.

Step 3: Investment selection and diversification

It is also sensible to diversify within each asset class. By investing across a range of geographical equity markets and sectors, for example, you can reduce risk further.

Which investments should I consider?

Rather than build a portfolio with individual shares and bonds which can be an expensive and time-consuming business, many investors choose investment funds, such as unit trusts, instead. This is where your money is pooled together with like-minded investors and invested in a wide range of individual holdings chosen by a professional fund manager. Each fund will state their aims and objectives from the outset and be clear about what they will invest in, for example a UK equity fund or a global bond fund.

You may prefer to invest in a fund of funds, where the fund manager invests in a portfolio of funds on your behalf rather than individual holdings. This approach means a greater immediate level of diversification and provides day-to-day management of both asset allocation and fund selection.

[†] Source: Financial Analysts Journal, 1986

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