Asset Classes

Key Points:

- An asset class is a group of investments that display similar characteristics and are subject to the same laws and regulations.
- There is usually low correlation, and in some cases negative correlation, between different asset classes.
- Portfolios are constructed by combining these different asset classes in order to diversify investment risk.

Introduction

An asset is anything that can be bought, sold or exchanged. An asset class is simply a category or group of assets. The traditional asset classes are cash, bonds and equities (shares) but other asset classes include commodities such as oil and gold, commercial property and art. The investor can choose whether to invest directly in an asset class, for example by buying individual shares or indirectly through an investment fund. An investment fund pools money from many investors enabling investors to share the cost of investing and to diversify risk.

Cash

Cash investments deliver returns through interest which can be paid out on a fixed or variable rate. Cash is suitable for the short term because it is secure and very 'liquid'. In addition to bank and building society deposit accounts, cash investments include certificates of deposit and treasury bills.

Cash investments are highly predictable and in a diversified portfolio can help offset the volatility of other asset classes. The down side is that returns are generally lower than those of either bonds or equities and may not keep pace with inflation over the medium to long term.

Fixed Interest

Fixed interest investments are also referred to as 'bonds'. They represent a loan made to a government or company. In return for your money the debtor agrees to pay a specified rate of interest and to repay the amount of the loan at the end of a pre-agreed period, the redemption or maturity date.

Government bonds are considered the safest type of bond as they are backed by government guarantees and are generally easy to buy and sell. Bonds issued by the UK government are known as 'gilt edged securities' or 'gilts'. Historically, the returns have not been as high as those afforded by corporate bonds. Corporate bonds are issued by companies to finance or expand their business. Generally they offer higher returns than government bonds but also carry a higher level of risk. Bonds are traded in much the same way as equities. The interest the bond pays, called the 'coupon', is usually a fixed percentage of the price at which the bond was originally issued. During its lifetime the bond can be traded. The capital value will be driven by demand which is in turn driven by two factors, interest rates and the credit worthiness of the bond issuer. For example, if the bond guarantees to pay out 5% per year and interest rates are only 3%, the bond is more likely to be in demand. However, if interest rates rise to 7%, the bond will no longer be in demand so its capital value will fall.

Bonds can offer a steady and predictable income stream as well as security of capital if held to maturity and the issuer does not default. Bonds are, however, susceptible to fluctuation in interest rates. When interest rates rise, bond prices tend to fall and vice versa.

Equities

Buying an equity, also known as a 'share' entitles you to a stake in that particular company and may give you the right to vote on key decisions and also to share in profits through the payment of dividends. High yielding equities seek to pay above average dividends. You can invest in equities at home and overseas. Over the long-term equities have out-performed fixed interest, commercial property and cash investments but are the most volatile asset class.

If an equity is in demand, perhaps because its profits are rising, the value of each share will subsequently be worth more, therefore, the share price will increase. Companies also reward investors by paying a proportion of profits to shareholders in the form of a dividend. Conversely, if a company's profits fall, it will reduce or suspend payment of dividend and generally its share price may fall as there will be more sellers than buyers.

In summary, equities have historically out-performed other asset classes and can provide a combination of income through dividend payments and capital growth. However, equities can be volatile and the share price

Hedging - To reduce the risk of an investment by making an offsetting investment.

Alternatives - An asset that does not fall into one of the conventional investment categories. Alternative investments include private equity, venture capital, hedge funds, art, antiques and commodities. Property is also often classified as an 'alternative'. investment.

Liquidity - The degree to which an asset can be quickly bought or sold in the market at a price reflecting its intrinsic value. In other words: the ease of converting it into cash.

can go down as well as up meaning you might not get back the amount you originally invested.

Commodities

Commodities are raw materials to include:

- Energy – oil and natural gas.
- Base and precious metals – gold, platinum and silver.
- Agricultural – corn, soybean, wheat.
- Industrial - cotton and copper.
- Soft commodities – cocoa, coffee, sugar.

Commodities can be a very effective means of diversifying risk and reducing volatility because they behave differently from equities and bonds, so commodities are "negatively correlated."

A current shortage of supply and growing demand has created a very strong market in certain commodities such as oil and industrials but conversely, commodity prices will suffer when there is a risk of economic slow-down.

Property

In the UK property has grown in popularity on the back of a strong housing market. As an asset class, however, property usually refers to commercial property such as shops, offices and retail parks. Commercial property can provide an income from letting as well as capital growth.

Capital returns from property have been higher than from bonds. Rental income is general slightly lower than the income yield paid on corporate bonds. Like commodities, commercial property tends to be negatively correlated with equities and bonds which means that property can still increase in value when equity and bond markets are falling. The down side is that property is a relatively illiquid asset that may prove difficult to sell and transactional costs are high.

Exposure to Property can be achieved by investing directly, or indirectly by buying shares in an Investment Fund.

Hedge Funds

Hedge funds do not represent an asset class such as equities and fixed interest. Instead they are an investment product that can include many asset classes. Generally, hedge funds seek out investments that appear to be wrongly priced and aim to produce positive returns in all types of market environment.

Hedge funds seek to protect the investor when there is sharp downward movement in the market. Hedge funds are flexible and focus on generating positive returns consistently. They are, however, very dependent on the skills of the manager. Furthermore, fees are performance related and can be high when the fund is performing well.