A guide to investment:
principles, drivers & terminology

DOMINION

Contents

1: An explanation of financial terminology

Active management: Active management is when investment managers take action (i.e. pick stocks) in an effort to outperform the market. To do this, they use proactive analysis, research, market forecasts, and expert judgement. As a result, active management fees are generally higher than those for passively managed funds, or index tracker funds, which only track the market.

Alpha: Alpha is a measurement of the difference between a fund's performance and the market's performance. It is often used as a measurement of fund managers' skills.

Analyst (financial analyst): A professional whose responsibilities include: collecting, analysing, and interpreting financial data, and preparing reports, models, and buy or sell recommendations.

Annualised rate of return: The annualised rate of return is the net return over a given period (e.g. 3 years) expressed as an annual percentage.

Asset: Assets include stocks, bonds, commodities, real estate, cash, property, works of art and other investments. An asset is something which allows you to earn money simply through owning it.

Asset allocation: It is possible to divide up the holdings in your portfolio by asset classes (e.g. equities, bonds, commodities, etc.). Each asset class performs differently, meaning that exposure to a higher number of them lets you mitigate risk.

Assets of a fund: The investments that are held within a fund.

Balance of trade (country): The difference in value between a country's imports and exports.

Balance sheet: A statement showing company assets and liabilities, and stating the outstanding shareholder equity.

Bear market: A market that is falling. Someone who believes the market is headed for a drop is often referred to as a "bear". Bear markets can last for a few weeks or years. The reason it's called a Bear market is that when a bear catches its prey it pushes it down with its paw.

Beating the market: Making an investment return that is greater than the return achieved by the stock market as a whole.

Beta: A measurement of an investment's sensitivity to market fluctuations. The higher a fund's Beta, the higher its sensitivity to market movements.

Blue chip: Blue chip companies have a long history of good earnings, good balance sheets, and even regularly increasing dividends. Owning equity in these companies might not be exciting, but is likely to provide reasonable returns over time.

Bond: Bonds are used by companies and governments who want to raise money. When you buy a bond, you are buying the promise that your money will be returned with interest.

Book value: The liabilities a company has minus its assets and common stock equity. Book value is usually used as part of a valuation measure, rather than being directly related to a company's market value.

Bull market: A market that is going up. If you think that the market is going to go up, you are considered a "bull." You can also be "bullish" on a specific company, meaning you think its stock price will rise. The reason it's called Bull market is because a Bull throws its prey upwards with its horns.

Capital gain (or loss): The difference between the price you paid for an investment, and the price you sold it for. If you buy 200 shares of a stock at $10 a share (spending $2,000) and sell your shares later for $25 a share ($5,000), your capital gain is $3,000. A loss occurs when you sell for less than you paid. So, if you sell this stock for $5 instead ($1,000), you have made a capital loss of $1,000).

Capital growth: An investment's increase in value over time (excluding income). Funds targeting capital growth aim to select stocks that will appreciate in value, rather than deliver ongoing income to investors. .

Cash: All money, paper or digital. In relation to funds, cash usually refers to the percentage of a fund that is on deposit rather than invested into another asset class. Often, this is because fund managers expect valuations to fall, presenting an opportunity to buy more cheaply.

Cash flow: The net amount of cash and cash-equivalents being transferred into and out of a business. At the most basic level, a company's ability to create value for shareholders is dependent upon its ability to generate positive cash flows (or, more precisely, optimise long-term free cash flow).

Collective investment scheme (CIS): Sometimes referred to as a "pooled investment", a CIS is a fund which multiple people contribute to. A fund manager invests the collective wealth in holdings belonging to one or more asset class (stocks, bonds, property, etc.).

Commodity: Commodities are an asset class made up of useful, tangible, goods, such as industrial and precious metals, oil and natural gas, and agricultural products.

Correlation: A measurement of any two assets' linear return relationship, and the extent to which their movements are related. Correlation can be any value between +1 and -1. Portfolios can be diversified by combining investments that have low correlation to each other. Correlation of +1 means assets have always historically moved in the same direction when markets change, whereas correlation of -1 means assets have always historically moved in the opposite direction.

Coupon (Bond): The yearly interest payment to bondholders, received from the bond's issue date until maturity. Coupons are normally described in terms of the coupon rate, which is the sum of coupons paid per year divided by the bond's face value.

Depreciation: An accounting method that allocates the cost of a material asset across its life expectancy. This measure makes it easy to see how much of an asset's value remains at any time. Depreciating assets helps companies earn revenue from an asset while expensing a portion of its cost each year the asset is in use, and can make a big difference to profits.

Derivative: Financial contracts whose value is related to the value of a financial index or underlying asset. Often used for risk management purposes (see 'Hedge') or to increase returns.

Diversification: The strategy of ensuring you have more than one type of asset in a portfolio, helping to reduce risk. This term does not just apply to asset classes, but can also be used in regards to different sectors, industries, or geographic locations.

Dividend: A payment made when a company decides to divide up some income amongst shareholders. Dividends can be paid as a one-off or they can be paid regularly (monthly, quarterly, semi-annually, or annually).

Dollar cost averaging: The effect produced by investing in a fund on a regular or frequent basis is described as dollar cost averaging. If asset prices fall, the regular payment buys more units, but if they rise, the regular payment buys fewer units. Unlike investing in a single lump sum, this approach mitigates the effect of volatile markets on your investments.

Dow Jones Industrial Average: A price-weighted list of 30 blue-chip stocks. Despite its small size, many people think of the Dow when they hear that "the stock market" gained or lost, and it is often used as a gauge of the whole stock market's health.

Earnings per share (EPS): The portion of a company's profit allocated to each outstanding share of common stock. EPS indicates how profitable a company is for the owner of a single share

Enterprise value (EV): A more comprehensive measure of a company's total value than equity market capitalization. EV includes the company's market capitalisation, short-term and long-term debt, and any cash on the company's balance sheet.

Equities: Equities are shares in a company. If you own a share or an equity in a company, it means that you are a part owner of it together with hundreds, thousands, or hundreds of thousands of other people.

Equity exposure: Literally, the amount of the fund that is exposed to (i.e.: contains) equities. If a fund's equity exposure is 30%, it means 30% of its value is invested in equities.

ETF: Exchange-traded funds are investment funds that mirror an index and trade like a stock. Investors buy and sell ETFs on the same exchanges as shares of stock, and gain exposure to an entire market as a result.

EURO STOXX: A series of equity indexes that only include shares of Eurozone companies. Designed by STOXX, an index provider owned by Deutsche Börse Group.

Exchange: A place to buy and sell investments, including stocks, bonds, commodities, and other assets. Today, most of these orders are executed electronically.

Fixed income: An asset class comprising bonds and gilts, where the amount of income paid out is fixed.

Free cash flow (FCF): A measure of the cash a company produces through its operations, minus expenditure on assets. Free cash flow can be used to determine whether a company will have enough cash (after funding operations and capital expenditures) to pay dividends and commit to share buybacks.

FTSE: The Financial Times Stock Exchange 100 Index is an equity index comprising of the 100 largest companies on the London Stock Exchange, measured by market capitalization. Also called the FTSE 100 Index, FTSE 100, FTSE, or, informally, the "Footsie".

Fund of funds: A fund that only invests in other funds. Funds of funds are either 'fettered' (meaning all of the underlying funds held in the fund of funds' portfolio will be managed by the same company) or 'unfettered' (meaning the underlying funds will be from different fund management groups).

Fund manager or fund management: The firm responsible for deciding how a fund should be invested. Working within established regulations, they can also be described as the 'fund provider'.

Futures: standardised financial contracts between two counterparties, in which the buyer purchases an underlying asset (e.g., financial instruments or physical commodities) at a pre-determined future date and price.

GARP (Growth at a reasonable price): When a company's shares are valued at a premium which is within the historic range (or not very different from comparable growth companies), but which is justified by consistent earnings growth, .

Gain: The profits made when assets are sold for more than they were bought for.

GDP: Gross Domestic Product (GDP) is the total value in monetary terms of all finished goods and services made within a country during a specific period. GDP can be used to estimate an economy's size and growth rate, and can be calculated in three ways (using expenditures, production, or incomes).

Government bond: A bond issued by the Government.

Growth fund: These funds target future gains, typically investing in stocks whose earnings outperform the market. A growth fund manager will try to achieve success by focusing on fast-growing sectors and looking for high-profile companies within them that deliver consistent earnings growth. Appreciation of individual share prices in the funds' portfolios is what drives these funds' growth.

Growth investing: This investment strategy focusses on capital appreciation. Growth investors look for high-growth companies and are often willing to pay higher prices for them in terms of metrics such as price-to-earnings or price-to-book ratios.

Growth rate (company): The amount by which certain values (such as turnover or profits) increase over a specified period. The terminal growth rate is made on the assumption that growth (or decline) will hold constant in perpetuity. Perpetuity growth rates tend to fall between the historical inflation rate of 2 - 3% and the historical GDP growth rate of 4 - 5%.

Hedge: The opening of a position intended to offset potential losses from another investment.

Historic yield: A measurement of dividends paid out over the previous year divided by the current price and expressed as a percentage.

Real implied growth rate: This measurement describes the market expectations for long-term earnings growth that is implied by a share price. Comparing a company's RIGR to that of its industry or the wider market can help investors identify over and undervalued firms.

Index: A tool that tracks the progress of a group of stocks, bonds, or other assets, that share certain characteristics.

Index fund / index tracker: A mutual fund which mimics an index's performance, letting investors gain exposure to a large basket of stocks in a single investment. These tend to be passive investments, and have relatively low fees.

Inflation risk: The risk that the purchasing power of savings will fail to keep pace with the rate of inflation.

Initial Public Offering (IPO): When a private company offers shares to the public in a new stock issuance. This allows the company to raise capital from public investors.

Interest rate risk: A measurement of a bond or fund's sensitivity to interest rate changes for the remainder of its lifecycle In the event of an interest rate increase, a decrease in price would correspond with higher interest rate risk.

Investment manager / fund manager: The person or company responsible for investing and managing the money held within a fund.

Investment objective: The objective that a fund was created to achieve. For example, the generation of income, provision of capital growth, or the protection of capital.

Liquid or liquidity: The speed and ease with which an investment can be bought and sold.

Long: To retain an investment in your portfolio on the assumption that its value will increase over time. (See 'Short').

Market capitalisation: A company's "market cap" is a measure of its size and / or value. A company's market cap can be found by multiplying its share price by the number of shares existing.

Small cap: Market cap <$1billion
Mid cap: Market cap $1 billion to $10 billion
Large cap: >$10 billion

Mixed asset funds: Funds that have the freedom to invest in a wide variety of asset classes, such as cash, bonds and shares. In theory, the fund's performance would not be reliant on any one type of asset.

Money market account: An interest-bearing account that usually pays a higher interest rate than traditional savings accounts.

Multi-manager fund: A fund which invests in other managers' funds as opposed to underlying assets (stocks, bonds, etc.). (See 'Fund of Funds').

Mutual fund: This type of fund purchases assets with money pooled from individual investors. The fund can hold individual stocks or bonds and is actively managed by a professional portfolio manager. As a result, these funds usually have higher fees than other investments.

NASDAQ: The National Association of Securities Dealers Automated Quotations. A U.S. exchange for buying and selling securities that is based in New York City. The term also refers to an index of the stocks bought and sold on the Nasdaq exchange.

NAV (net asset value) of a Fund: The entire summarised value of a fund's liabilities and assets. This can be expressed as a total fund size in monetary terms or as a price per unit.

NYSE (New York Stock Exchange): One of the most famous stock exchanges in the world. The NYSE trades stocks in US and some international companies.

Open-ended fund: A fund where the number of shares or units in existence can increase or decrease as investors buy-in or sell-out of the fund In theory, the number of units that can be created is unlimited, hence the use of the term "open ended".

Passively managed funds: (See: index fund / index tracker).

Performance: A measurement of elements such as capital growth & income paid against the wider market, sector or other benchmark. (See 'Total Return').

P/E ratio: How much you pay for company earnings. If a company reports earnings of $5 per share, and each share is selling for $75, you can work out the P/E ratio as follows: divide 75 by 5. The answer is 15. In other words, you have paid $15 (when you bought the share) for every $1 of earnings (in the time specified – companies usually report earnings once per quarter). The higher a P/E ratio is, the greater expectations are for higher earnings.

Portfolio: A collection of investments.

Pound cost averaging: (See dollar cost averaging).

Personal investment strategy: There are many different approaches to investing. Individual investors should learn how investing works and decide on a personal strategy that's right for them.

Provision: Items in a company's accounting records that represent funds put aside to pay for anticipated losses or costs.

Public company: (Alternatively: a publicly traded company, publicly held company, publicly listed company, or public limited company). A company which is owned via shares of stock traded on a stock exchange or in over-the-counter markets.

Real return: The rate of return on an investment once inflation has been accounted for (e.g.: if an investment returns 10% over a year but inflation is 3%, then the real return is 7%).

Recession: Usually defined as a decline in GDP (gross domestic product) for two consecutive quarters.

Redemption: When an investor sells shares back to a fund manager. In most funds, investors can redeem part or all of their investment at the fund's next valuation point and receive cash shortly thereafter.

Return: A fund's return consists of two main elements - the income earned by an investment minus costs, and appreciation in an investment's capital value. Combined, these are a fund's total return.

Risk profile: All investors have a risk profile, which is used to describe the extent to which they can face the loss of capital, or failure to reach investment goals.

Risk rating: A measurement of a fund's risk rating. It lets investors gauge a fund's potential to increase or decrease in value. Usually, higher risk funds exhibit higher volatility.

Sectors: Funds can be grouped into "sectors" defined by investment objectives, or classes of investment.

Share: A unit of ownership in a company or a Fund.

Sharpe ratio: The amount of excess return an investment offers for each additional unit of risk (expressed as a standard deviation) compared to a risk-free asset. The Sharpe ratio shows whether returns are due to intelligent investment decisions or an abundance of risk. The higher the Sharpe Ratio, the better the risk-adjusted return, calculated as:

S = (return of the portfolio – return of the risk-free asset) / standard deviation of the portfolio

Short: Selling an investment which you do not currently own (often achieved through the use of derivatives). This is done in the hope that it can be bought later at a lower price, therefore allowing the seller to make a profit. It is, effectively, betting against a stock.

Standard deviation: A measure of a portfolio's total volatility. It indicates the degree to which a portfolio's returns have varied around the average during a set period of time. The lower this measurement, the lower the risk.

Stock market, or stock exchange: An electronic system in which trades take place between buyers, sellers, brokers, and dealers. Securities, bonds and shares are the assets traded.

Stop loss: An advance order to sell a stock once it falls below a certain price threshold. Stop loss systems are used to limit the loss one incurs when an investment performs poorly.

Style/Investment style: The theory and strategy that dictates how an investment portfolio or fund is managed. One example is value investing, which looks to discover and invest in undervalued companies.

Switching: When an investor sells their holdings in one fund and buys shares in another fund managed by the same firm, they will usually have to pay a switching fee.

S&P 500: The Standard & Poor's 500 is a stock market comprised of 500 US companies. Like the Dow Jones, it is also a stock market index.

Stock: (See Share. See Equity)

Total return: A combination of the total income received from an investment (minus costs) and its capital return.

Tracker Funds: A tracker fund mirrors a specified index, holding all of that index's stocks and copying its pattern of buying and selling shares. The goal is to mimic an index's performance, thereby gaining access to the performance of an entire market.

Unit: Just as an equity is a share of a company, a unit is a share of an investment fund. It indicates a proportion of ownership of the fund in question, and entitles its bearer to a proportionate share of the fund's investment returns.

Valuation: A calculation of the overall value of a fund and the price of a single unit in that fund, including its assets and liabilities.

Value investing: An investment strategy that involves picking undervalued stocks. Value investors hope to benefit from buying stocks that the market is underestimating.

Volatility: The measurement of an asset price's movement up and down over time. More volatile stocks are, by definition, riskier - however, they sometimes provide better returns in the long run.

Yield: If you are a dividend investor, your yield is the ratio between the price you paid for the stock, and the dividend it pays to you. For example, if a stock is trading at $100 per share, and pays out a dividend of $5 per year, you can find the yield by dividing the $5 by $100, and turning it into a percentage. In this case, the yield would be 5%.

2: Valuing companies and their equity

Investors use company valuations to help them make sensible investment decisions, and have traditionally focused on profit (or "the bottom line") when producing them. However, other financial indicators have started to play an important part in company valuations, as focusing on profit has not always provided a reliable guide to investment.

Some of the most important company valuation concepts to be added to an ever expanding toolbox are cash flow, net asset value, and enterprise value. A company's cash flow refers to the cash it generates, and is usually approximated by the sum of profits and non-cash items in a company's profit & loss account (such as depreciation and provisioning). A company's net asset value refers to the value of its assets, excluding liabilities. And a company's enterprise value (EV) is the sum of its equities' market value and its debt's market value. EV is commonly used in mergers and acquisitions but is also popular with equity investors.

EV is the basis for many valuation measures, which show, for example, the ratio of EV to sales. Investors also often calculate the free cash flow of a company (residual cash flow after interest costs and taxes are taken into account) and examine the ratio between it and EV. This is known as the free cash flow yield (FCF yield), and is often used in mergers and acquisitions. If the FCF yield is higher than the cost of debt, it could make sense to acquire a company, as its free cash generation could cover the cost. Discounted Cash Flow (DCF) methodology is another tool used to determine a company's valuation. This method is often used in capital investment decisions and can help to decide if a particular project will generate enough revenue to cover expenditures.

Dominion Asset Management also often applies the implied growth rate (G) as a valuation measure. It represents a company's growth rate in perpetuity. (The starting point is the so-called Gordon's Growth Model $G = k - \text{FCF Yield}$; where k is the required rate of return for investor)

The stop loss system is designed to avoid major losses, and is often based on the so-called "high watermark" (the highest price of the stock since its addition to the portfolio). The stop loss signal is triggered when a company's share price falls below the stop loss level.

Quoted Equities

Of all asset classes, equities have shown the greatest potential for returns historically. However, they are also amongst the riskiest, since their values can fluctuate significantly.

Growth investors look for companies offering strong earnings growth.

Key characteristics of growth stocks are:

- they are high-priced in the short term because they are expected to deliver higher growth in the long term
- they have attractive earnings growth records
- they are usually more volatile than the wider market

Value investors look for stocks that are undervalued, and hope to reap the rewards of future profits.

Key characteristics of this strategy are:

- a belief that markets overreact (over-shoot) to bad news
- the search for stocks which are priced lower than both the broader market and similar companies in the same industry
- a potential value trap: companies may be cheap for a reason, and value investors can misunderstand those reasons. In these cases, the apparently cheap stock is in fact correctly priced by the market

Growth at a Reasonable Price (GARP) is an investment strategy that combines key facets of both growth and value investing. Investment guru Warren Buffett is a well-known fan of this type of investing.

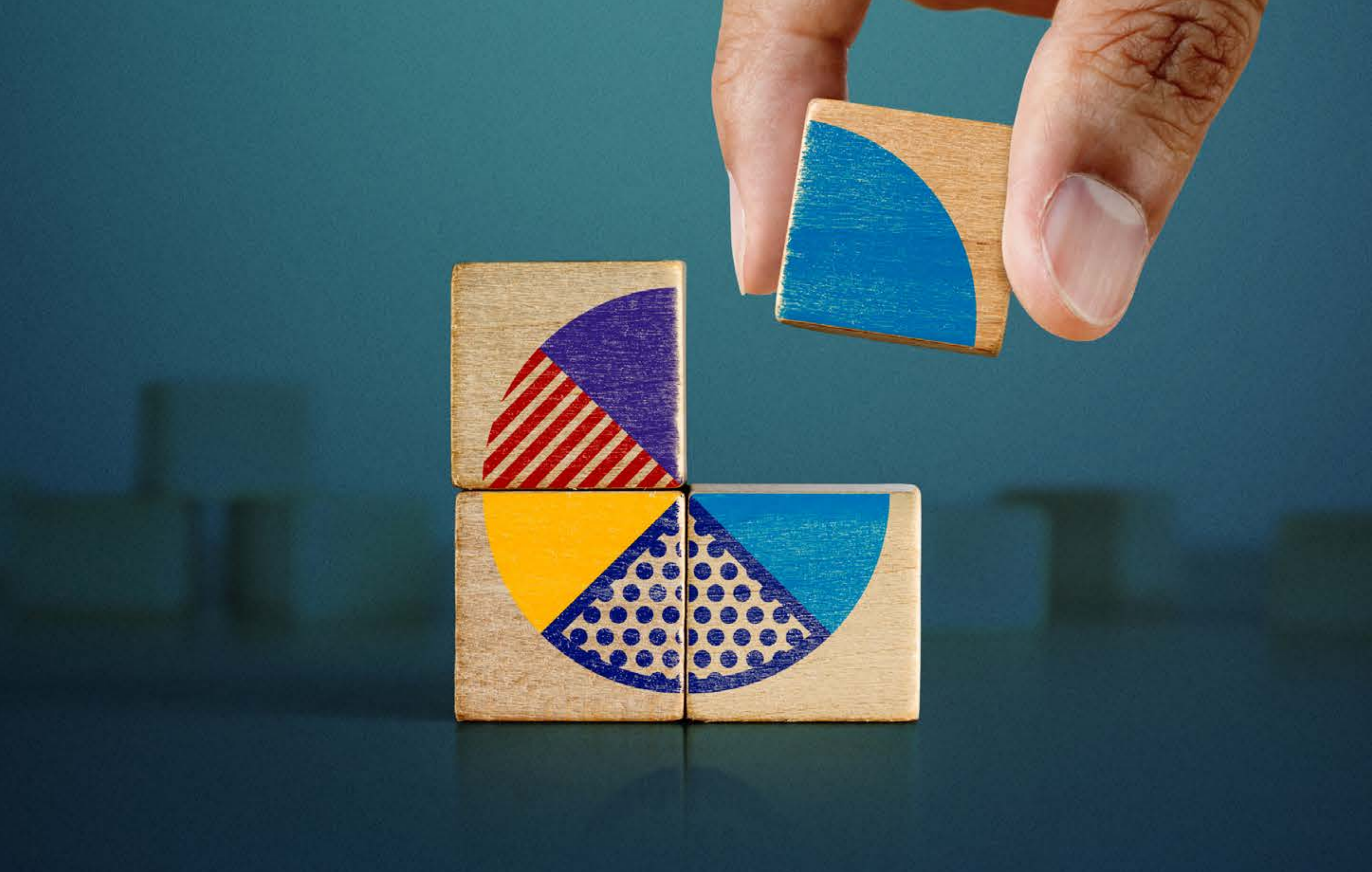
Market capitalisation (market cap) is defined as the total value of all outstanding shares of a publicly traded company. It is a rough measurement of a company's value. Definitions of small, mid, large and mega cap companies are straightforward – but the exact thresholds between these levels varies from market to market.

Drivers of equity markets

The macroeconomic environment is a major driver of equities. Other, more equity-specific, drivers include what are known as "company fundamentals". These are a business's economics, such as the balance sheet, income statement, cash flow, and overall management Taken together, these measures are thought to be indicative of a company's health and growth prospects.

Financial analysts use company valuations to determine the amount they will pay for a stock.

Market expectations are, essentially, investors' opinions about a company's prospects, based on the future returns that are implied by its stock price. It is important to note that equity markets tend to be similar to other markets in this regard: they are forward looking and price in expectations.



3: Economics - the building blocks of investment

A country's economy as a whole is referred to as a macro economy. Macroeconomics is the study of economic data and methods at this "macro" level, examining areas such as gross domestic product (GDP), unemployment, and inflation, to help governments determine the aggregate effect of certain policies on an economy.

Governments will usually strive for:

- A low and stable rate of inflation (typically around 2%)
- Equitable distribution of income to create a fair society, without major divisions between rich and poor
- Unemployment remaining around the natural level (unemployment and inflation are often linked)

The total economic output of a country is called Gross Domestic Product (GDP) and reported (usually on a quarterly basis) by national statistics offices. GDP indicates whether the economy is growing or contracting.

The formula for determining GDP is the sum of consumer spending (C) plus investments by firms (I) plus spending by governments (G) plus the difference between exports (X) and Imports (M): GDP= C+I+G+(X-M).

In contrast, microeconomics works on a "micro" scale, looking at the behaviour of individual economic units such as companies, industries, or households within an economy.

4: Economics - inflation

When consumer demand increases, it can cause short term scarcity of products. This limitation of supply then causes prices to rise. For example, if avocados become the next new superfood, demand will rocket and supply run low. The price of avocados will then increase, as people would be willing to pay more for them.

Inflation can also be caused by an increase in production costs. For example, if sterling depreciates, it will cause avocados, which are bought in Peruvian Sol, to be relatively more expensive as an import. In this case, British supermarket chains are likely to pass off at least some of this increased cost on to consumers in the form of higher prices.

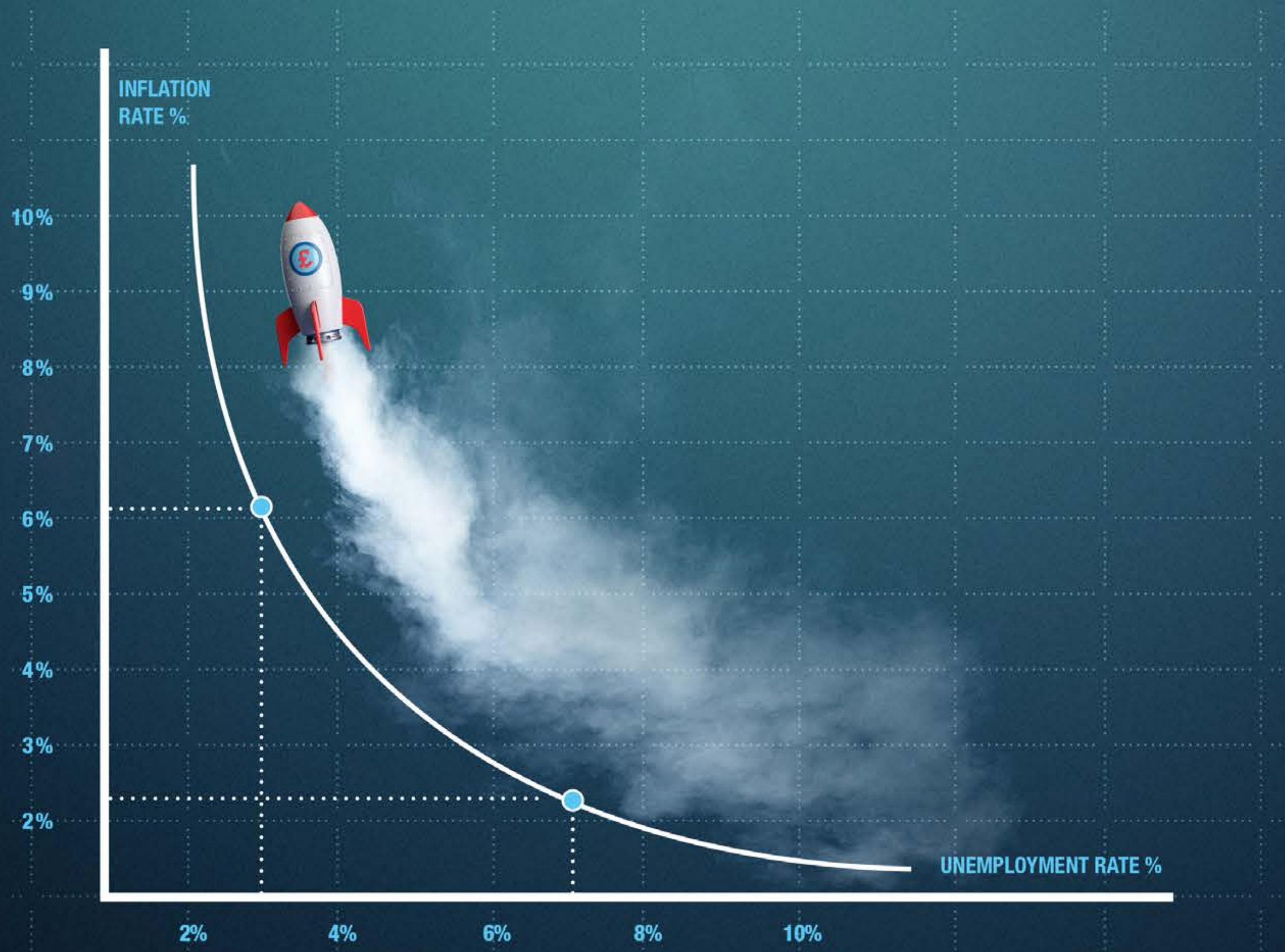
The term inflation refers to an environment of generally rising prices within an economy. Rising prices impact the cost of living, the cost of doing business, borrowing money, and mortgages. If it is not balanced out by rising wages, etc., then increasing inflation causes consumers' purchasing power to decrease. The measure of inflation over time is referred to as the inflation rate.

Deflation is the opposite of inflation: a general decline in prices. It emerges when the supply of goods and services in an economy increases in tandem with demand for cash on the part of both corporates and consumers.

Sometimes, bouts of deflation can be a positive thing, as it can increase the purchasing power of money. But long periods of deflation are considered negative for an economy, as consumers and businesses hoard cash and reduce demand, expecting to benefit from continued falling prices.

Stagflation is a term that describes increasing inflation alongside a fall in GDP – it arises from a combination of the words "stagnation" and "inflation".

A Goldilocks economy is when growth isn't too hot (leading to inflation) nor too cold (leading to a recession). A Goldilocks economy is a healthy economy with a favourable GDP growth rate of 2-3%, and moderately rising prices, as measured by the inflation rate. While deflationary cycles have proved hard to reverse, central bankers are generally confident in their ability to control rising inflation.



5: Economics - welfare

Unemployment occurs when a person who wants work is unable to find it. It is often used as a measure of an economy's health. The unemployment rate (the total number of unemployed persons divided by the total number of people in the labour force) is the most frequently used measure of unemployment.

Individuals might be unemployed for a variety of reasons, such as the seasonal nature of some jobs (ski instructors, fruit pickers or those involved in the tourist trade) or brief periods of joblessness due to a change in career. And, of course, companies occasionally fail, and are forced to make their staff unemployed. Structural unemployment is more serious, and occurs when unprofitable sectors stop employing workers.

The Phillips Curve is an economic concept that shows how unemployment and inflation are related in an economy. It suggests that decreasing unemployment causes an increase in inflation, and vice versa, and is a popular tool for macroeconomic analysis.

6: Government policies

Monetary and fiscal policies are the primary ways in which governments seek to achieve their goals

There are three broad approaches here:

1. Conventional monetary policy: how central banks control the supply of money in an economy, usually by targeting an inflation rate or interest rate.
2. Unconventional monetary policy: unorthodox measures used when conventional policies are insufficient.
3. Fiscal policy: government use of taxation and spending.

In conventional monetary policy, central banks control the supply of money through the use of interest rates, which are set to achieve the desired unemployment/inflation rate. When an interest rate is changed, it affects the cost of borrowing/saving. Increased rates incentivise investors and consumers to pull back from spending, as the cost of borrowing money has increased. As a result, less money circulates in the economy. This causes a fall in the inflation rate.

On the other hand, reducing interest rates makes it cheaper to borrow money. This incentivises spending and investment, increasing the money circulating in the economy. Generally, this causes inflation to rise.

Quantitative Easing (QE), which is the creation of new electronic money by a central bank, is the major approach in unconventional monetary policy. This new money is used to buy financial assets (such as government bonds), thereby stimulating the economy. When large amounts of government bonds are purchased, it increases the money supply and can reduce the cost of borrowing. In theory, this should encourage private sector spending, creating higher asset prices in turn and helping to return inflation to its target.

Fiscal policy is the adjustment of government spending and tax rates to affect the economy. Depending on the desired outcome, fiscal policy is implemented through economic stimulus or austerity measures. To stimulate an economy, the government will lower tax rates and commit to public spending. Whereas, if a government wants to lower budget deficits, it will engage in austerity measures, such as increasing tax rates and reducing government spending.

7: Exchange rates

An exchange rate can be defined as the rate at which one country's currency can be exchanged for another's. Since currencies have value relative to one another, a depreciation in one country's currency causes others to be more expensive.

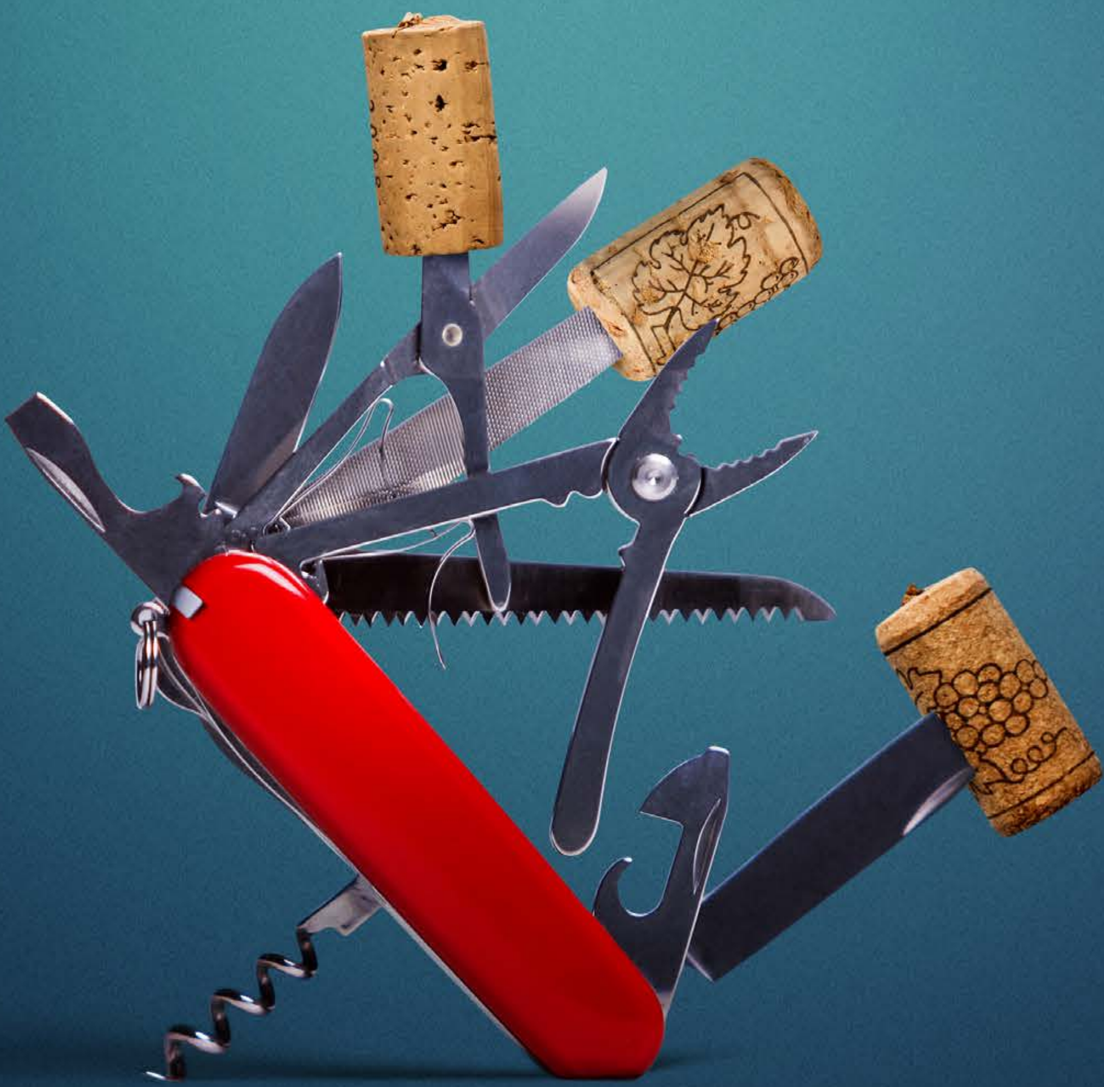
When exchange rates fluctuate, it can have a major impact on an investment portfolio's performance. For this reason, it is vital that asset managers remain aware of how much exposure they have to each currency. Investment managers can vary currency exposures (for example through the use of hedging at various exchange rate levels), thereby letting them adjust overall exposure as needed.

A number of factors can affect exchange rates.

The most important include:

1. When a country with lower **inflation rate** sees its currency value rise, causing its purchasing power to increase against that of other currencies. The result is that countries with higher inflation usually see their currency depreciate.
2. Higher interest rates attract an influx in foreign capital, causing the exchange rate to increase. However, due to the correlation between interest rates, inflation and exchange rates, the effect of this move can be reduced.
3. A deficit in the country's **current account** signals that it is failing to generate enough foreign trade to compensate for spending. Put another way, the country's demand for foreign currency outpaces its supply, which lowers its exchange rate.
4. A country's currency exchange rate can also be affected by its debt rating. Widespread concerns over the possibility of a debt default can lead investors to sell bonds denominated in the relevant currency, resulting in depreciation.
5. A number of factors, such as political events or changes in commodity prices, can lead to speculation which may cause currencies to fluctuate in value. Foreign exchange rates are highly influenced by sentiment in financial markets.

Investment managers often seek to protect against (sudden) exchange rate changes by currency hedging. Hedging is an effective way of limiting the risk posed by foreign exchange, but it can also be expensive.



8: Fixed income: the lower risk option?

Fixed income securities are investment assets which provide returns in fixed periodic payments, as well as the eventual return of the original investment. These are usually low risk/low reward strategies, and therefore an important component in low-risk investment propositions.

Governments, agencies, corporates, banking and other financial institutions, can all be fixed income issuers.

The sensitivity of a bond's price to interest rate changes is measured in duration. This incorporates a bond's yield, coupon, and maturity, and is expressed as a number of years.

When a yield curve inverts, it is often seen as a leading recession indicator. An inversion means that yields on short-term bonds are higher than those of long-term bonds, and suggests that investors expect interest rates to decline in the future, possibly in tandem with a slowing economy and lower inflation.

Alternative Instruments

Many assets, such as precious metals, art, wine, antiques, coins, real estate, commodities and private equity, are classified as alternative assets. Due to their unique nature, these assets tend not to correlate with traditional asset classes, meaning they may be suitable to diversify portfolios.

Cash

Of all assets, cash is the safest but comes with the lowest returns.

There are three reasons to hold cash in a portfolio, which are:

1. Liquidity and opportunity: When asset class valuations drop to attractive levels, investors that have quick access to cash can take advantage of them.
2. Reduced portfolio volatility: Holding cash in a fund limits exposure to more volatile markets (such as equities). Consequently, when stocks fall, having a large amount of cash in a fund offers protection from volatility.
3. Protection against crisis: Cash is the safest asset of all, making it invaluable when political and economic uncertainty presents itself.

Remaining invested is crucial

Interest rates are close to their lowest level in history, meaning that saving money offers no worthwhile return. However, to find the "real" interest rate, you have to adjust it for inflation. Before the financial crisis, interest rates were higher than inflation – you could leave your money in the bank, go for lunch, and when you returned your wealth would have increased (however slightly). However, when interest rates are below inflation, every month you leave your money in the bank makes you poorer in real terms.

9: Investment management approaches

Active management: where an investor pays a professional to actively select investments, attempting to beat the market and minimise losses.

Active managers use analytical research techniques, such as bottom-up and top-down research to buy, sell and hold securities. Active management can be undertaken by individuals (single manager), co-managers, or teams of investment specialists. Actively managed funds track their performance against a benchmark, and look to deliver better returns.

Key advantages:

Active managers can use highly regarded research for investment ideas which can give them an edge over the wider market when it comes to stock picking. They can also minimise losses by avoiding certain investments.

Key disadvantages:

The major disadvantage with actively managed funds is that it can be expensive to work with professionals and pay for their in-depth research. Particularly when style bias can sometimes limit performance, and there is no guarantee that managers will always pick a "winner".

Active managers use a number of investment styles: Top-down looks at the macroeconomic factors first, focusing on the economic big picture, whereas bottom-up considers microeconomic factors first, such as the health of individual companies. Non-directional funds attempt to deliver consistently stable returns regardless of market performance.

Inefficient markets, such as emerging markets or smaller companies, are often better accessed via active managers, who can use their professional skills to compensate for the lower coverage of investment banking research, geographic, cultural, and language barriers, and unorthodox business models. This gives them insights that other market participants do not have, letting them generate additional returns. The cost of tracking less-liquid markets is also higher than for efficient markets, driving down the cost differential between active and passive management.

A mutual fund is a pool of funds collected from individual investors to invest in securities such as stocks, bonds, cash, or funds. They can be active, passive, or a mixture of the two. A mutual fund can be thought of as a corporation that brings investors together and invests their money as one lump sum. These funds are managed by an investment manager, who works to deliver capital gains and income. Each mutual fund comes with pre-defined investment objectives which it is structured to deliver.

Passive fund management

Passive funds mirror an index or market, looking to perfectly replicate its performance rather than beat it, and will either contain an exact replica of the index in their portfolio or a representative sample of it. Investors can access passive investment approaches through exchange-traded funds (ETFs), unit trusts or open-ended investment companies (OEICs). ETFs trade like a common stock on a stock exchange, whereas tracker funds (which are essentially the same as ETFs) can only be traded once a day.

Factor Investing is a modern technique which systematically recreates traditional portfolios through the use of low cost, exchange traded instruments. Factor investing considers underlying factors that determine the risks associated with asset classes, such as the price trends of the equity market, a company's size, or a bond's sensitivity to interest rates. This approach delivers a more comprehensive picture with greater accuracy. Factor investing peers into the market's underlying nature, and goes way beyond a basic understanding of asset classes.

A few examples of different factor investing styles are: Liquidity (this strategy compensates investors who put their money in less liquid, and thereby riskier, assets. The strategy is usually executed through the buying of illiquid assets). Momentum (this strategy relies on short-term fluctuations in a security's price, rather than its fundamental value. Put simply, momentum investors look to buy expensive shares and sell them when they become even more expensive. The Carry Trade (this strategy makes use of low interest rates to borrow, then investing the money in an asset which provides a higher yield).

Compounding is the practice of continually reinvesting both capital growth and interest, creating an ever-increasing base on top of which accumulated assets can grow over time.

Performance Measures

Alpha equals the percentage of a return which is down to the manager's skill.

Beta a comparison between the volatility of a portfolio's returns and that of the market index. Beta represents the extent to which a security's returns respond to market swings. In other words, Beta provides an indication of what kinds of movement investors should expect from a security when the broader market rises or falls.

An investment's **volatility** is the variability of its individual returns, over a certain period of time, relative to its average return over the same period. It is a measure of how predictable an investment's returns are. The higher the volatility, the more a security's value can quickly show dramatic jumps and drops. Conversely, lower volatility means a security's value is more stable, and changes at a steady pace over a longer period of time.

The **Sharpe ratio** is a comparison of a portfolio's return versus a risk-free return. It shows the average return an investment delivers for each unit of risk over and above the risk free return that serves as basis for comparison. The greater the Sharpe ratio, the more an investment is returning for each unit of risk. Because a Sharpe ratio calculation just returns a raw number, it is mostly used in comparison to other funds' Sharpe ratios. This measure has become the industry standard for risk-adjusted comparisons between investments.

Other Relevant Performance Terms:

Hurdle rate - This mechanism sets a minimum rate of return to achieve before a fund manager receives compensation (i.e.: a fee) and offers investors protection from underperforming investment professionals.

High-water mark - Generally used in the context of performance-based fund management compensation. Similar to a hurdle rate, managers must get the fund above the high-water mark before receiving a performance fee on the assets under management.