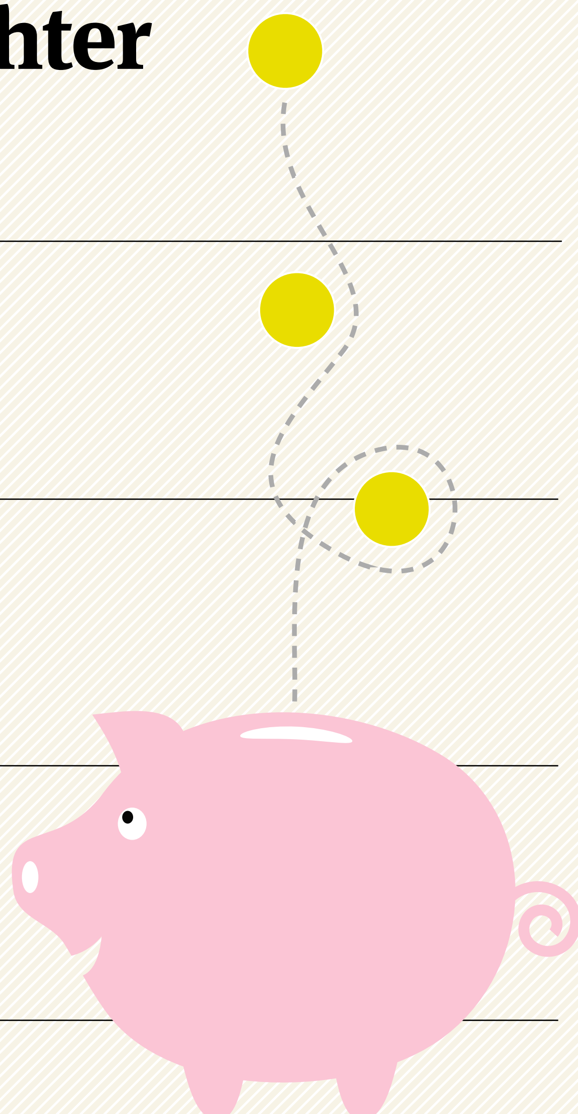
AN INVESTORS CHRONICLE PUBLICATION

THE BASICS FUNDS **SHARES** INCOME **ISAS** ALTERNATIVES **TAX**

HOW TO GET STARTED IN **INVESTING**

Your guide to a brighter financial future



GETTING STARTED

Perfect investment planning
How to set investing targets that meet your needs

Build a better portfolio
Lower your risk with diversification

CHOOSING INVESTMENTS

Funds for your portfolio
Take the legwork out of investing using collectives

Get to grips with the stock market
How to choose and buy the right shares

MANAGE YOUR PORTFOLIO

Monitor your money
Make sure your portfolio meets your objectives

Avoiding investment pitfalls
Don't let charges and common errors dent your returns

Supported by Alliance Trust

Introduction

CONTENTS

HOW TO CHOOSE A TRUST *p10*

Time to take control

Taking a hands-on approach to managing your personal finances has never been more important, says **John Hughman**

For most of us, barring an unlikely sweep on the National Lottery, the prospect of making it onto the *Sunday Times* rich list isn't very likely. But being comfortably well off is something we all aspire to be – and it isn't an unrealistic ambition. Working hard and spending our well-earned cash wisely, leaving some to squirrel away, is half the battle to achieving financial peace of mind.

Today, though, being a hard worker and assiduous saver isn't enough. Interest rates are at record lows and likely to remain so for some time – which means that if you put money in a savings account its value will be eroded by inflation. In other words, as each year passes your money will buy less. Many of us will be lucky enough to receive some form of company pension, but even these are much less generous than they used to be – as corporate pensions have shifted from 'defined benefit' to 'defined contribution', we know how much we're putting in but no longer have any idea of what we're likely to get out in retirement.

The answer is to invest yourself to get better returns. And while there is a perception that playing the stock market is a gamble, this needn't be the case if you do your homework and take a disciplined approach. In short, don't view investing as a get-rich-quick scheme and take silly risks as a result. Most of the world's most successful investors subscribe to the theory of getting rich slowly. It's a simple but wise philosophy.

That's not to say that starting out in the world of investing isn't still hugely daunting – the investment options available to you are almost limitless, and the financial services industry isn't always that helpful in helping you make the best choices. However, giving up before you even start is probably the worst financial decision you could ever make, which is why we've put this guide together – to help you overcome your fears and set you on the road to the financial well being you deserve.

John Hughman
Editor

Getting started

Get yourself ready to invest

Once you've decided to take control of your financial future, consider three questions before you take the plunge

Why should you invest? After all, it sounds like a load of extra hassle you could do without. It's complicated and there are risks lurking around every corner.

But don't let that put you off. Investing sensibly can give you and your family financial security for life, including all the way through your retirement years. It can see you through the bad times and make the good times even better. Best of all you will be in control of your finances and as there's no one who will be quite as keen to make sure your best interests are always being served, that can only be a good thing.

Nor need it be complicated. Investing can be very simple if you choose to keep it that way. You can avoid manias, panics and crashes if you stick to some basic rules.

First, though, it is important to accept that there will be risk involved. The very process of investing involves taking on some degree of risk. What investments are we talking about? Everything from cash, managed funds, bonds, shares (large and small cap, domestic and international), all the way through to property.

Your returns will be made in one or two ways: an income stream generated by the holding and/or a rise in the capital value when you sell the asset. Before you invest a penny, think about three questions:

- What do I want?
- How long have I got to save for it?
- Who am I and how much risk am I prepared to take on?

The first two questions are easiest to answer. Do you want a reliable income stream, or are you looking primarily to make capital gains? Are you investing for a specific purpose – for example, university fees for your children – or an income generating portfolio to allow you to retire five years early?

What is your timeframe – are you investing money that you're likely to need access within a year? Five years? 10? Even more? The answer will have a huge bearing on what you end up doing. Put simply, the longer you've got, the more risk you can afford to take.

> "Put simply, the longer you've got, the more risk you can afford to take"

'Who am I?' is a bit trickier. Start by being honest about what sort of a person you are. Successful investing requires time, patience and discipline. If you're a busy person and you don't have much time, then stick to simple products and systems, rather than things that are going to require lots of research.

Finally, look at your overall financial position. There's no point rushing into investing if you've got heavy debts elsewhere, or if you know you're going to have to make major financial commitments that will hoover up all your spare money.

How much can you invest? £100 a month or £500 a month? Perhaps you have come into a significant capital sum, say £20,000. How much you can put in will partly determine what you invest in. If you only have a small sum of spare cash each month then a tracker fund might be the best solution.

Before you start investing

- Get your debts, if you have any, under control.
- Make sure you have a rainy day fund – or insurance – in case of unforeseen disasters such as sickness or unemployment. Three to six months' worth of salary is often advised.
- If your employer offers workplace saving or a pension scheme, consider joining it – especially if the employer contributes.
- Decide on your objectives and timeframe, if possible by completing an investor policy statement. You can find one at *http://bit.ly/1gMQGpl*.
- Your first investments should be into general/global funds, for example a FTSE All-Share market tracking fund. You can then build on your core holdings with more specialist niche sector funds and individual shares.
- Build a practise portfolio, either by using a stockbroker's online facility or by closely following a small number of shares.
- Choose a stockbroker (*http://www.investorschronicle.co.uk/2012/09/06/shares/news-and-analysis/how-to-choose-a-stockbroker-in7EAJE3q-gYypG3rVrDtVN/article.*html.) Setting up an online account is straightforward. The most common way to hold shares is electronically in a nominee account, but make sure you are entitled to receive company reports and accounts.
- Think about using a self-select Isa, if your allowance isn't being used elsewhere, to avoid paying unnecessary tax on dividends and capital gains.
- Only invest money you can afford to lose.

Time for your first steps

Choosing where to invest isn't as difficult as it might first look. Just follow our simple steps

Once you've decided you want to start investing, the next step will be to decide what you want to invest in, and how. Yet the options on offer can be bewildering, and it's quite understandable that with this tyranny of choice many would-be investors might think about giving up.

However, once you've completed your personal investing profile things get easier, and you should have a better idea of where your starting point should be.

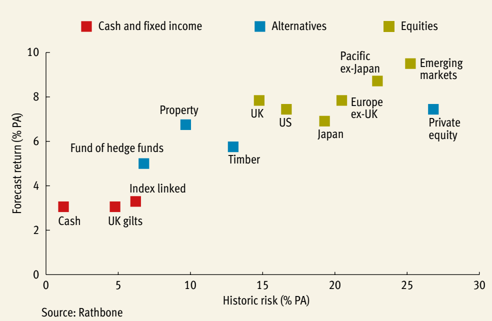
If you've decided that you enjoy the cut and thrust of the markets, and have time to devote to managing your portfolio, you'll be able to do much more of the legwork yourself. In this case you might be interested in shares, which involves some degree of research, including looking at accounts and graphs. We'll show you how the stock market works and how to go about choosing shares shortly.

If that doesn't sound like your idea of fun, then stick to collective investments such as funds, exchange traded funds (ETFs) and investment trusts, where somebody else does all the hard work for you, or which simply track market indices passively. Again, there is a massive choice of such vehicles on offer, but we'll explain how you can make sure you select the ones best suited to your needs and which are likely to generate the returns you require.

Collective investments can also give you exposure to alternative asset classes, such as commodities or property. These can be a useful way to diversify your exposure, because they don't move in lock-step with shares. In investing speak we would describe them as 'uncorrelated'.

However, even if you take the 'hands-free' funds route, you'll still need to keep an eye on your portfolio to make sure it continues to meet your objectives.

Forecast returns



Source: Rathbone

We'll show you how to manage your portfolio later in this guide, and how to set realistic targets for the returns you're likely to achieve.

Risky business

Another thing you can't avoid in investing is risk – and certainly not if you want to enjoy above-average returns. Your attitude to risk is also an important determinant of what you buy. As a rule of thumb, the greater your tolerance of risk – or, to put it another way, the greater the returns you seek – the higher the amount of shares as a proportion of your total assets you should own. The chart above demonstrates the likely returns you can achieve from various asset classes and the relative risks of each.

How you weight your portfolio between these assets is known as asset allocation. It's one of the most important decisions in investing and is also a very important method for managing risk.

We'll explain these concepts in more detail on page 6 of this guide, but it goes back to the principle of correlations – in other words, you want assets whose returns don't always move in the same direction.

How to buy

Once you've decided what you want to buy you'll also need to work out how you're going to buy it and, just as importantly, hold it. All investors should take advantage of the tax breaks on offer to them via individual savings accounts (Isas) or self-invested pension plans (Sipps).

Isas are the UK's most popular savings and investment vehicle – unsurprising given the generous tax break they offer. They essentially come in two forms: cash Isas and stocks and shares Isas, which protect your investments from capital gains tax and also the income tax (beyond the 10 per cent tax credit deducted at source) you'd otherwise incur on the dividends and interest you receive.

Sipps have also become popular as a way, as the name suggests, for investors to manage their own pension pots. Sipps offer similar tax advantages to Isas, but come with the advantage of tax relief as you pay money in.

Most mainstream assets are eligible for inclusion in Isas and Sipps, but there are exceptions. Don't forget of course that you have tax allowances to start with – more on these on page 20.

There are a multitude of providers offering these products, from stockbrokers to high street banks. There are many factors influencing which one you go with, but to our minds the most important deciding factor is cost. We'll explain more about why you should consider charges on page 7.

Diversification

Build a better portfolio

A portfolio diversified across asset classes can cut the risks of investing

When it comes to investing it's worth heeding the maxim 'don't put all your eggs in one basket'. Investing always carries risks, so it's good to spread your money around so that one poorly-performing investment doesn't damage your returns.

But there is an even more important reason for diversifying – that running a portfolio that includes a range of assets alongside equities, such as bonds, property, and cash, is proven to account for the bulk of returns over time. This process is known as asset allocation, and is almost always the starting point that any wealth manager will take when helping their well-heeled clients decide where to invest. "The asset allocation decision is by far the most important factor in determining long-term results," said banker Ron Sandler when he reviewed the UK savings industry on behalf of the government in 2002.

But why is this? In short, because different asset classes don't move in lock-step with one another, when one is weak another may be performing well. Invest in a single asset class, and the chances of avoiding a sell-off are much lower – indeed, a bear market in shares, for example, could wipe 40 per cent from the value of your investment, which could be difficult to recoup. There will be years when you don't do as well as the market with a diversified portfolio, but over multi-year periods you'll be able to sleep easy as your wealth steadily builds up.

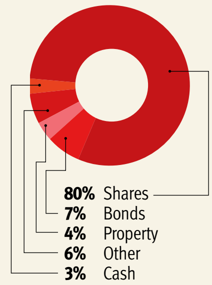
That's one reason why many advisors recommend that you change the way you allocate your assets over time – for example, as you move towards retirement, preserving your wealth or generating an income may become more important to you than growing your portfolio, so the type of asset you buy will change. Equities are seen as more risky than government bonds, which is why conventional thinking suggests your allocation to bonds should increase as you become older, because you'll have less time to recoup any losses. However, others believe that a loss of capital in the early years of a portfolio is worse.

Ultimately, how you decide to weight your holdings is primarily dependent upon your personal circumstances, attitude to risk and investment objectives. If you want higher returns, you'll need to take on more risk, usually in the form of a higher weighting of equities. If you're more cautious, the rule of thumb is that you should have more safe-haven assets such as government bonds, cash, or near cash assets such as money market funds.

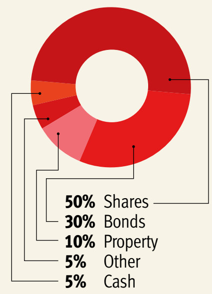
Increasingly, professional investors are using asset allocation techniques on a much more tactical basis, according to the short-term outlooks and shifting valuations of different asset classes. Investors Chronicle has now developed a service that can help retail investors use the same techniques – and the rise of exchange traded funds (ETFs) means it's easier than ever to make these tactical adjustments. Tactical allocation is also important to reflect the fact that correlations between asset classes change over time – so an approach to diversification that worked successfully in one year might not in the next.

Portfolio styles

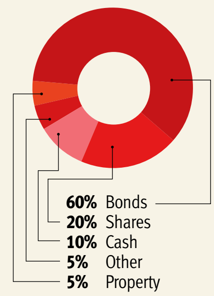
Adventurous



Balanced



Cautious



Off the shelf allocation

One limitation of the asset allocation approach is that to spread your cash across asset class you need quite a bit to invest – which means for those just starting out on their investment journey it's impractical. However, it's possible to buy collective investments which aim to pass on the benefits of asset allocation to the private investor through a single product.

One example is multi-manager funds, where you invest your money with one provider which employs fund managers to manage each specific asset class and manage the allocations between them. By pooling money, multi-manager funds are also better able to access certain asset classes that private investors might find difficult to access, such as wholesale bond markets, hedge funds or private equity. Similarly, you may look to buy funds that perform a part of the asset allocation process, such as multi-country equity funds or strategic bond funds that can invest across both government and corporate bonds.

Choosing a platform and managing costs

Keep a lid on costs

Comparing platform and fund costs isn't straightforward, but is essential to avoid fees eating into your returns

It is often the last thing that investors think about but it should be one of the first: charges and fees. It's vital to pay close attention to what you pay for products and services. You need to think of charges as a corrosive liquid eating away at your profits and to take steps to avoid it or minimise it as much as possible.

So, to avoid handicapping your performance, always check the charges even when picking cheap passive or index-tracker funds. Can you find a similar fund for a lot less elsewhere? If you are choosing an actively managed fund, check the make up of the fund and its performance over different time periods. This is to ensure you are not paying excessive charges for what is in effect a tracker fund, or for dismal performance. And remember that investment trusts may be a cheaper option.

But comparisons are not always easy to do. A lack of transparency in showing what charges are, along with a lack of consistency in how charges are calculated, makes straightforward comparison between funds difficult. A fund's annual management charge won't reflect all costs. Look for a total expense ratio or an ongoing charge as these will give a better indication of the true cost to you each year.

You might come across the terms 'clean' and 'superclean' pricing: these relate to funds that no longer pay a trail commission (this was money paid to financial advisers and platforms from your fund holdings for years after a recommendation to buy into the fund) and to platforms that have negotiated lower annual fees for their clients.

Choosing a platform

Besides the charges and management fees deducted from any funds you own, you will also have to pay a platform provider for the administration of your funds and Sipp (a self-invested pension) portfolio.

The biggest ones are run by Hargreaves Lansdown (*hl.co.uk*), Fidelity (*fidelity.co.uk*) and Barclays Stockbrokers (*barclaysstockbrokers.co.uk*). Others include *iii.co.uk* and *youinvest.co.uk*. The platforms all charge a fee for their administration services and then dealing charges on top but comparing their costs is not straightforward. Help is at hand from websites such as The Platforum *(theplatforum.com)* to help you work out which one is most cost effective for you.

Do your research thoroughly as switching platforms can be a costly business thanks to transfer-out fees levied per holding.

Recently all the main platform providers have been announcing their new fee prices following the abolition of trail commission. Costs can vary significantly.

An investor with £500,000 invested with Hargreaves Lansdown divided between £150,000 in an Isa and £350,000 in a Sipp, each with half in equities and half in funds, with 10 transactions per year would pay £3,405. With Interactive Investor the same investor would pay £2,344.

Share and self select Isa charges

If you manage a portfolio of shares, you will need to use a stockbroker nominee account to manage your holdings. Costs are not the only factor to consider when choosing a stockbroker, but they are hugely important.

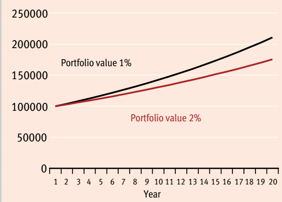
Execution-only dealing fees have become much more competitive – the average cost is around £10. However, stockbrokers have taken a leaf out of the budget airlines' book and introduced extra charges, such as inactivity and administration fees. Watch out for these! You can get around inactivity fees by trading, but the other fees can rarely be avoided.

Cheap and not so cheap

There is an incredible disparity between fees charged by funds for doing exactly the same thing, so shop carefully.

The Virgin FTSE All-Share Tracker Fund, for example, has a total expense ratio of 1 per cent. Buy the Vanguard fund tracking the exact same index however and you would pay an ongoing charge of just 0.15 per cent. Or compare Neptune Emerging markets which has a high ongoing charge of 2.61 per cent with iShares Emerging Markets ETF with a charge of just 0.75 per cent. Over time these differences add up to large sums of money.

Charges hurt



Investors Chronicle

An extra 1 per cent charge can knock 17 per cent from a portfolio's value over 20 years

Compare stockbroker charges here:

investorschronicle.co.uk/2012/09/06/shares/news-and-analysis/how-to-choose-a-stockbroker-in7EAJE3q-gYypG3rVrDtVN/article.html

Get the best from funds

Funds open the door to every market and sector, making them ideal first holdings. But where to start?

Funds are collective investment schemes that pool your money with other investors' money to invest in a range of assets such as shares and bonds or even property. They can be unit trusts or exchange traded funds (ETFs) or another structure called an open-ended investment company (Oeic). Sometimes they are sold as pre-wrapped Isas so that you get tax advantages, too.

Your holding will be measured in units (if it's a unit trust) or shares if it's an ETF or Oeic. Investment trusts are another type of fund and we look at these separately on page 10. You do not have a say in how your money is invested – that's up to the fund manager who makes all the decisions on your behalf. The value of your holding will rise and fall in line with the fund, and the manager will keep you informed of the progress of the fund, what his or her strategy is going forward and how the problems in the wider market or economy are affecting performance.

The advantages of funds are that they make great core holdings, and are a cheap and easy way to invest in the stock market with just small amounts of capital. And because your money will be spread over many holdings rather than just one or two, they should reduce the risk you are taking on. They are ideal for most investors who do not have enough capital to start their own well-diversified portfolio. Investing in more than one fund increases portfolio diversity and it is perfectly possible to invest solely through funds, avoiding individual shares altogether. Funds are ideal if you don't have confidence in your own stock-picking ability.

But there are also disadvantages. For example, with a unit trust if a lot of people want to exit the trust at the same time – and this can happen when a market goes into a steep and sudden decline – you might face restrictions on time and or amounts when trying to get your money out. While this is rare, another flaw is that in difficult markets the fund manager might be forced into selling his best, most liquid holdings in order to meet redemptions.

Funds offer an enormous variety of investing opportunities: you can buy into all the world's main stock markets; you can focus on the markets' biggest companies – or their smallest ones. There are funds that focus on particular sectors such as emerging markets, commodities or natural resources. Others aim to deliver either capital growth or a high income. Some funds offer both.

Fund managers have become very well-known. It is worth remembering that managers sometimes move between funds, and that the performance of a particular fund may be affected by a change of manager.

A crucial thing to note is that funds can be active or passive. An active fund is one where the manager selects individual holdings and aims to deliver a better performance than the market as a whole. With a passive fund, the manager tracks a certain market – for example, the FTSE 100 – by replicating the make up of the market.

So, that's funds in a nutshell. Now the difficult bit: how do you choose a fund from the thousands on offer? That will depend on your investment objectives, how long you can invest for and what investments or savings you already have in place. If you are starting out, for example, and intend to invest for the next 10 to 20 years, you can be braver than someone who's only planning to invest for three years. But start by looking for a solid core holding such as a general market tracker fund and then build on that with more focused, possibly higher-risk fund holdings.

What to consider

- Does the fund meet your investment objective – eg, for income, capital growth?
- Look at the past performance of funds in your shortlist. It's easy enough to source performance statistics for funds over different time periods such as one, three, five and 10 years. You should also look at performance in discrete years to check for consistency and compare the performance against the market. You can do this at websites such as *morningstar.co.uk* and *trustnet.com*. At *investorschronicle.co.uk* you can create a graph to show how the fund has performed against a benchmark.
- Are you overexposed to one sector or market? You might have found three brilliant funds but if they all hold the same mix of shares, what's the point?
- Look beyond the UK. It makes sense to have your core holdings in your home market – there's no currency risk and you can easily keep abreast of developments and newsflow – but as you add to your investments, it's worth buying into overseas and developing markets for two reasons. The first is to avoid putting all your eggs in one basket, although many markets do rise and fall in line with each other these days. The second is to gain exposure to high-growth economies.
- Who's the manager – have they been in place for the whole period that you've been examining?
- Is the fund expensive for what it offers and what it has achieved?
- Read The IC Top 100 Funds guide at *investorschronicle.co.uk* for suggested holdings.

Funds

Active or passive funds?

Should you take a chance on higher-cost active funds or stick with passives? Here's what you need to know before deciding

One debate that never ends in the investment world is that about active versus passive investing. There are passionate advocates on both sides, so we look at why the two styles matter, what the differences between them are and what the main arguments in favour of each one are. We also suggest how it's possible to combine them so that you get the best of both.

Active management is where the portfolio manager chooses which holdings to buy and sell, when and in what quantities. Active managers try to spot mispriced securities and market inefficiencies. They can have bad years but their aim is to ensure that over time their returns outperform the market; in other words, that your gains beat what you would have got by tracking the market average performance.

Passive funds – such as index trackers and exchange traded funds (ETFs) – simply replicate the returns of a specific index and stick with those indices through thick and thin. With no professional investment manager taking (good or bad) portfolio decisions, the fees charged for a passive investment tend to be a great deal less.

Advocates of the active approach contend that a good fund manager will deliver outstanding performance, something passive investors can never expect. In weak markets, the active fund manager can anticipate problems and take action to avoid them whereas in a falling market passive funds have no choice but to sleepwalk into disaster. They also argue that in certain markets – for example, those following the onset of the global financial crisis in 2007 – active investing is the only way to go as managers can hand-pick attractively valued, robustly financed and durable growth companies.

Another argument in favour of the active approach is that active managers can diversify risk better. For example, the FTSE 100 is heavily exposed to exchange rate risk and commodity prices. Oil and gas and basic resources account for more than 28 per cent of the FTSE All-Share and nearly 24 per cent of the FTSE 100.

The passive camp has three main arguments, but they are all pretty compelling. The first is performance, the second is cost and the third is not getting what you are paying for with active funds.

On performance, the theory is that active fund managers should be delivering far higher rewards than passive ones but the reality is they aren't. A study by passive fund provider Vanguard found that, in the bear market between 1999 and 2003, more than half of active managers of UK funds underperformed the FTSE All-Share. During the subsequent bull market (2003-07), the study found that two-thirds of active managers underperformed the All-Share.

Another study by wealth manager SCM Private found that over five years to the end of February 2010, nine out of 10 of the main Investment Management Association (IMA) fund sectors underperformed their indices. Yet you are charged a premium for such underperformance, and the impact of those costs over time is alarming. Over a decade, studies show that active management ends up costing almost £2,000 more than passive.

In addition, many so-called active funds are in effect closet trackers as they hold lots of stock in the same proportion as the index that they use as a benchmark for performance. Research from SCM Private has found 40 per cent of a typical UK equities fund is simply a 'clone' or 'copy' of the overall UK stock market, with that portion being identical in weightings to the FTSE All-Share Index.

The best of both worlds

Given the compelling arguments both for and against active and passive funds, many investment specialists believe that the best option is to use a combination of these in your portfolio.

A popular model is to use passive funds as the core, giving exposure to mainstream markets such as the US and UK, and possibly Japan and Europe, with a few active funds in the periphery to provide outperformance and exposure to less mainstream areas.

Certainly, where a market is very efficient – for example, the US – it is harder to beat the index than in less efficient areas such as emerging markets.

Another potential factor is your investment timeframe. A good active manager can add a lot of value over the long term, even if there are periods where he or she has underperformed a benchmark. Conversely, the low cost of passive funds make them useful for 'nipping in and out' of markets.

Splitting your portfolio into active and passive sections can also help with a common mistake investors make – holding too many stocks in their portfolios. Avoid this by having your core holding in passive funds to reduce costs, surrounded by satellite holdings of actively managed funds and investment trusts, or direct stock holdings that you feel have superior investment prospects.

One example of a very simple portfolio would consist of three passive funds or ETFs: a broad-based domestic equity fund, a broad-based foreign equity fund and a domestic bond fund.

Even if you have decided to use a passive fund in a certain market, you then face the problem that not all passive investments are created equal. Investors need to look into the tracking difference of a passive fund or ETF to find out how closely the fund tracks its index.

Investment trusts

Trust in trusts

Investment trusts should be the first port of call for all new investors. Here's why

Like unit trusts, investment trusts – the oldest form of collective investment – pool your money together with other investors' to buy shares and other assets. They are similarly managed by a professional investor who with the help of a team of analysts makes all the investment and strategic decisions.

However, there is one major difference between unit trusts – which are more commonly referred to as funds – and investment trusts. Unit trusts are 'open ended' vehicles, which means there is, theoretically, no limit to how much money they can take from investors because they can create more units in response to demand (although they do sometimes close to new investment). Conversely, investment trusts are 'closed-ended', with their size limited by the number of shares in issue on the stock market, which is where they're listed. The advantage of being closed-ended means the portfolio managers always know how much capital they have to manage and do not need to worry about having to sell high-quality assets simply to meet investor demands for their cash – which partly explains why they've marginally outperformed unit trusts over the years. All investment trusts have independent boards of directors to look after the interests of shareholders, just as other companies do. They can, and do, sack managers.

There are around 400 investment trust in total listed on the London Stock Exchange – far fewer than the 2,000 or more open-ended funds available in the UK. However, they still offer access to an extremely diverse range or markets and asset classes. You can choose from giant global trusts that invest in hundreds of different companies in dozens of different countries, to trusts that invest in companies in a single company or sector. You can find out about the different types of trust and all the different sectors at *www.aic.co.uk* and you can check past performance at *www.morningstar.co.uk* and *www.trustnet.com*.

There is one other thing that distinguishes investment trusts from other funds. The shares that you buy can be worth more, or less – and sometimes a lot less – than the value of the underlying investments. This matters because you could be overpaying... or picking up a bargain. For example, if a trust has £100 invested in shares, and 100 shares have been issued, then in theory each share should be worth 100p. If the shares are only trading at 90p then they are trading at a 10 per cent discount to the net asset value (NAV), the value of the investments an investment trust holds. This means you are buying the shares for 10 per cent less than they are really worth. While some investors view this as a chance to pick up shares cheaply, others worry that the discount could keep growing. Shares can trade at a premium to NAV, too. If the same shares are trading at 102p, they are said to be on a premium of 2 per cent.

A manager with a good following and a strong track record will generally result in a premium. If a sector is in high demand, for example, income, expect the shares to trade on a premium. Share prices move all the time and the level of discount or premium will change depending on sentiment towards the type of assets the trust is investing in, or towards the managers of the trust.

Investment trusts are allowed to borrow money to invest. This works well when the investment performs. Returns will be boosted. But there is always a risk that the investment will fail and that could cost the trust and its investors significant sums of money. Trusts have to state their borrowings – this is known as gearing – so check if you are comfortable with the policy on gearing and the level it's at. A trust with high borrowings is said to be highly geared.

To invest in an investment trust, you simply buy shares. You can buy shares through a stockbroker or you can invest lump sums and or regular monthly amounts using an online platform, for example Alliance Trust Saving (*www.alliancetrust.co.uk*), The Share Centre (www.thesharecentre.co.uk) or Barclays Stockbrokers (*www.barclaysstockbrokers.co.uk*). We discuss the advantages of regular investing on page 21. Like shares and funds you can hold your investment trust shares in an Isa to secure tax benefits.

The impact of charges

There are two measures – the TER or Total Expense ratio and the Ongoing Charge - to help investors gauge the overall impact of costs on a trust's performance. The average TER including performance fees, on investment trusts is around 1.3 per cent compared with 1.6 per cent for unit trusts. Some trusts charge performance fees. This means if the manager beats a set target, he or she can cream off even more of the returns as remuneration. You can do a quick comparison of charges on the Association of Investment Companies' website at *www.aic.co.uk*. It shows the ongoing charges for its member companies expressed as a percentage. Big global growth trusts tend to be the cheapest of the lot, with fees on average of less than 0.6 per cent.

How to choose a trust

To help you narrow down the choices, first draw up a shortlist of trusts that appear to meet your requirements, for example global growth or high income. Look at:

- The objectives of those trusts
- Their strategies for achieving the objectives.
- The manager's track record.
- The manager's length of tenure and experience.
- The performance data.
- Gearing levels.
- What's in the portfolio.
- The charges that you will pay.
- Whether the shares are on a discount or a premium.
- Consider the (long-term) outlook for that sector.

Advertorial

Alliance Trust

Investment Focus:
Smart Insight from Alliance Trust

You've spoken. We've listened.

Introducing your free online source of information, help and expert opinion.

investment-focus.co.uk

Based on real insight, we have launched a new website which focuses on investment education. We believe that we are uniquely positioned to provide this hub of information based on the reputation we have built for trust and transparency over the last 125 years.

What can you expect to see?

Here we have provided a sneak preview of just some of the information you will find on the Investment Focus hub. We will be updating the site regularly so make sure you sign up for our email alerts to be informed when new topics are published.

Understanding funds

Written by Emma Simon, Personal Finance Journalist

For the vast majority of investors the simplest, cheapest and most pragmatic way to invest is through pooled funds.

One of the principles of investment is that diversification helps reduce risk. But it is expensive, and time consuming, for ordinary savers to buy shares of 80 to 100 different companies and keep track of how each is performing.

Learn more about investing for growth or income, exploring different investment remits, how to invest and keeping track of your investments. www.investment-focus.co.uk

Nobody's perfect: why we all make irrational decisions

Video interview with Professor Phyl Johnson, Consultant Psychologist

The fact that many of us make irrational decisions when it comes to our finances is widely debated and is often referred to as behavioural finance. In this short video we talk to Professor Phyl Johnson, Consultant Psychologist and Visiting Professor of Executive Education at Strathclyde Business School, about why this is and more importantly about what we can do as individuals to avoid it.

Learn more about how we make financial decisions. www.investment-focus.co.uk

Everything you need to know about fees

You'll naturally take a keen interest in the performance of your investments. But it's just as important to understand the fees you will be paying, as they can have a significant impact on the returns you achieve. Knowing what the different types of costs mean, and exactly what they consist of, can prove rewarding.

Learn more about fund, platform and financial advice fees. www.investment-focus.co.uk

Risk information

Investments can go down as well as up. You may get back less than you originally invested.

Alliance Trust does not give advice. You need to ensure you understand the risks and commitments before investing. If you are unsure you should consult a Financial Adviser before investing.

This has been approved as a financial promotion by Alliance Trust Investments Limited for the purpose of Section 21 of the Financial Services and Markets Act 2000. Alliance Trust Investments Limited is a subsidiary of Alliance Trust PLC and is registered in Scotland No SC330862, registered office 8 West Marketgait, Dundee DD1 1QN, is authorised and regulated by the Financial Conduct Authority, firm reference number 479764.

Exchange traded funds

Lifting the lid on ETFs

Covering a wide range of asset classes and regions, exchange traded funds open the door to many sectors and markets

Exchange traded funds (ETFs) are one more option on the menu for investors in funds. They are computer run, passive investment vehicles offering extremely cheap exposure to a wide variety of markets and sectors.

What they offer is an incredibly cheap way of tracking whole markets, sectors or any number of specific indices – for example, the FTSE 100 or the FTSE UK Gilts All Stocks index. Some track pools of assets based on a set of pre-decided criteria.

Their cousin – the exchange traded commodity (ETC) – tracks commodities, such as metals, natural energy resources, and agricultural goods. In most cases, ETCs directly track the performance of a commodity, but sometimes this is not possible and the ETC will instead track an index that measures the commodity's value instead.

ETFs are good as core holdings because they are a cheap way to get exposure to major indices such as the FTSE 100, and can be used as building blocks to make up a portfolio. Given that ETFs now cover such a wide range of asset classes and regions, you could consider constructing an entire portfolio of ETFs, although if you do this it is important to get your asset allocation to different geographies and sectors right.

Many investors hold FTSE 100, US and global ETFs as these make good core holdings in a portfolio.

One of ETFs' selling points is that they are cheap and it's true that their annual running charges can be extremely low. However, some general index-tracking funds can be cheaper, while buying and selling ETFs through online platforms or stockbrokers (unlike unit trusts, ETFs are listed on the stock exchange) can be quite expensive for small or regular savers. So even if you do find a cheap ETF, the dealing costs could outweigh the low TER and make an index-tracking fund more attractive – you need to watch out for this.

ETFs are associated with passive index tracking but providers are increasingly launching what they call smart beta ETFs. Rather than tracking a mainstream index such as the FTSE 100, they track indices constructed to have a special focus – for example yield, or to minimise risk.

Examples of such ETFs include ones based on minimum volatility indices, which seek to offer reduced volatility compared with standard market capitalisation weighted indices; funds that track bond indices put together on the basis of countries' gross domestic product (GDP) rather than the bonds issued; or enhanced commodity ETFs which try to track spot prices more accurately.

Smart-beta ETFs are still different to active funds as they aim to track rather than outperform an index and they tend to have lower costs than active funds. Smart beta ETFs can also offer greater transparency than active funds as they allow you to check what the funds are holding on a daily basis, and as they are listed shares you should be able to sell them quickly if you want to, which may not be as easy with a traditional active fund.

It is worth checking exactly what you are buying as small differences in costs compound over time and rip large chunks out of your returns. You should also have a look at the difference between the various indices and how closely the ETF tracks them.

Physical versus synthetic ETFs

ETFs replicate their index in different ways. One of these is synthetically. Here, derivatives are used to replicate the performance of the market. Often, they are more accurate than physical funds (which invest directly) but they come with a set of different risks. The major risk with synthetic ETFs is that the swap counterparty defaults, say, because it has become insolvent and is not able to honour its obligation. But some ETF providers such as ETF Securities, iShares and Source use multiple swap counterparties on their synthetic ETFs so if one fails then there are others to fall back on.

Physical ETFs can also be exposed to risk. That's because some of them lend the securities they hold as a way to boost revenues, which can help their returns and reduce costs for investors. The main risk with this is that the borrower does not return the assets, say, because it has become insolvent, so the ETF typically holds assets worth the value of the securities it has lent out.

Most viewed ETFs on Trustnet

Rank	Fund	Group	Focus
1	ETFS Physical Gold	ETF Securities	Commodity/Energy
2	iShares £ Corporate Bond UCITS ETF	iShares	Fixed Interest
3	iShares UK Dividend UCITS ETF	iShares	Equity
4	iShares MSCI World UCITS ETF Inc	iShares	Equity
5	iShares S&P 500 UCITS ETF Inc	iShares	Equity

Source: Trustnet

Investing styles

Income or growth?

Many shares and funds are categorised as either income or growth. Is one type better than the other, and how do you choose between them?

Income or high income funds and investment trusts, and high-yielding shares generally – all going well otherwise – pay their shareholders a regular stream of dividends. Clearly, these types of holdings will have great appeal to those investors who are in need of an income right now – for example, because they are retired.

Other investors like high yielders because they can reinvest the dividends into even more shares, rather than taking the cash, as this helps them to build a sizeable holding without the need to pour in more capital. If it sounds like a no-brainer, it isn't always. That's because often a high yield goes hand in hand with a share whose price has collapsed and which could fall further.

A low share price can mean investors expect little or no growth in future years. It can also mean simply that no one wants to buy the shares because the company isn't in good shape.

For other investors, the income stream matters less. They might prefer income at a later date when they fall into a lower tax band, for example. Right now they want investments that will grow in value. When they come to sell them, they can use their annual capital gains tax allowance to avoid a tax bill altogether or partially on the gains they have made.

For some people, investing is mostly about growth and the thrill of finding the next big company – the new Apple or Asos. They hope that the shares they buy today in an unknown company will one day reward them with a huge increase in the original value.

But growth investing carries many risks, not the least of which is that so many young and start-up companies go bust before they've had time to change the world.

> **For some, investing is mostly about the thrill of finding the next big company**

There is also the risk that their clever idea will be successfully copied by competitors.

Another risk is that you will overpay for those precious growth prospects. They may never materialise.

Some things to consider

■ Choosing between income and growth investments really depends on your investment objectives and horizons. You can include a mix of both in your portfolio and, of course, there are plenty of funds that offer both income and growth.

■ A good global growth fund can be a good core holding for your portfolio. Global funds have the greatest potential for growth as they can find opportunities in all parts of the world.

■ Consider 'defensives' both for their income streams and their ability to outperform in a bear or falling market. Defensives include companies such as tobacco manufacturers and utility companies.

■ Spotting successful growth investments is not easy.

Drips

If you own dividend-paying shares, but aren't dependent on the income from them, you may want to consider using the money to buy more shares. They, too, will generate dividends to reinvest. It's called compounding and the cumulative effect over a number of years can be astounding. One hundred pounds invested in equities at the end of 1899 would be worth just £168 in real (inflation adjusted) terms without the reinvestment of dividend income, but with dividend reinvestment, the portfolio would have grown to £24,184 (Source: Barclays Equity Gilt Study 2013).

Here's an example that shows how this phenomena works over an even shorter time frame. Let's assume you bought 1,000 shares in XYZ plc for 400p each with a yield of 4 per cent (16p a year). And it grows the dividend by 5 per cent a year and its share price increases by a similar figure. Over 20 years, the stake would be worth £16,200, including £5,500 of dividends, giving an annualised return, or compound annual growth rate (CAGR), of 7.2 per cent. However, if you had used income from the original holding to buy shares in the company, your investment would now be worth £23,200 (£8,800 of dividends used to buy shares), a return of 9.2 per cent. If that same stock had paid out 6 per cent each year, the final stake would have been worth over £34,000 – an annualised return over 11.3 per cent.

Many blue-chip companies offer what's known as dividend reinvestment plans, or Drips, to simplify this process for you – instead of paying you the cash, the company automatically issues you with more shares to the equivalent value. Even if companies don't offer this, most stockbrokers, Sipp and Isa providers offer an equivalent service – you'll be charged a flat rate, so it's only cost-effective for larger holdings.

Getting started

Investing in shares

Before you decide to invest in stocks and shares, it's a good idea to understand exactly how they work and what you're buying

When you buy a share, you become a part owner of the equity of a company. Selling shares is a way companies can raise money (with the alternative being debt either borrowed from banks or in the form of bonds). Any company can issue shares, but we're interested in those that you can buy and sell on stock exchanges, which can be found in most countries, and are usually referred to as 'public' companies.

The UK's public companies are almost all traded on the London Stock Exchange, which is split into two main parts. The first is the main market, which includes the 'blue-chip FTSE 100 market, the UK's largest companies, and other constituent indices of the FTSE All-Share including the FTSE 250, Small Cap and Fledgling indices. These indices are updated quarterly, with companies moved between indices depending on changes to their market capitalisation (the share price multiplied by the number of shares in issue).

The second of London's markets is the Alternative Investment Market, or Aim. This was launched in 1995 as the UK's high-growth market, and has traditionally had less stringent listing rules to attract less well-developed companies. However, for this reason Aim is generally perceived as more risky, and more suitable for experienced investors. Yet while there are indeed many speculative companies on Aim – such as tech and biotech minnows or resources explorers – it is increasingly home to some large and very well-established companies with long and successful trading histories.

Deciding which shares you want to then buy will depend, above all, on your investment objectives, how long you're prepared to hold them, and what degree of risk you are comfortable with. Shares that you expect to rise in value such as those on Aim are known as growth shares. The downside of these is that they'll be somewhat riskier, because they tend to be more expensively valued in anticipation of profit growth in the future, and they may not grow as quickly as expected.

As a rough rule of thumb, the larger the company, the lower the risk, but bear in mind you could be sacrificing the potential growth you could achieve by investing in smaller company shares. That, though, is more likely to be compensated for by reliable dividends. Dividends are the payments companies make to their shareholders, usually twice a year although some companies pay quarterly or issue special one-off dividends. To receive the dividend you need to own the shares on a certain date once it has been announced – this is known as the ex-dividend date, and is almost always a Wednesday.

Technical pointers to buying shares

Before you buy a share it's worth understanding that the price of a share isn't always as it seems. The price you'll often see is the mid point – it's half way between the bid and offer price, which are the prices that you can buy and sell the shares at respectively. The difference between these two prices is known as the bid-offer spread and is very important to look at – a wide spread suggests the shares are difficult to trade, and essentially mean you could be in a significant losing position on an investment from the moment you buy. Shares with a wide spread tend to be those that are dependent upon market makers to fulfil your order and aren't traded on the generally more liquid electronic order book, known as SETS. Along with the spread another useful measure of liquidity is the Normal Market Size, the number of shares that a market maker can trade at the quoted price. The lower the figure, the less likely you are to be able to get that price.

Usually the cheapest option for trading shares is online via an execution-only stockbroker, and can be as cheap as an £8 flat fee per trade. Execution-only brokers will simply transact your trades but not usually give you advice like some brokers, which tends to be more expensive.

How many shares?

One important question to ask is, how many shares should you own? The short answer is, not too many. While it's good to diversify to some extent, when it comes to shares the benefits of diversification tail off quite quickly – research suggests you shouldn't hold more than 20, and that adequate diversification can be achieved with as few as 10. Beating the market is very hard to do, especially if you build a huge portfolio of shares – because the more you hold, the more likely it is that you will buy shares that simply track one another's performance.

Where are my shares?

When you buy shares, they will remain in the custody of your stockbroker or Isa/Sipp provider. In the case of Isas and Sipps, they are legally required to be held in a pooled nominee account along with the shares of other investors'. To the outside world, these shares will be nominally owned by the broker/provider, but you will be the beneficial owner, and receive all associated dividends. An alternative is to own paper share certificates, where you are the named owner of the shares – however, this service can be expensive, and you have to take great care of the certificates, because if you lose them you won't be able to trade the shares and they are expensive to replace. You can also gain nominal ownership through CREST accounts, where you aren't issued certificates. However, these are rarer and can also be expensive. Certificated and CREST holdings are administered by a company's registrar, which also often let you buy and sell through them. In the UK there are three main registrars, Equiniti, Capita, and Computershare.

How to choose shares

There are many tools available to help you evaluate whether a company's share price is going to rise or fall and many investors start with fundamental analysis

Once you've set up a stock-broking account, and are ready to start investing, how do you choose which shares to buy? There are over 3,000 companies whose shares are listed in London, and whittling that down to the few that may be suitable for your portfolio may seem like a daunting challenge.

Whether you want to buy exciting growth shares or dull-but-worthy income shares, you still need to do some research to make sure the investment case stacks up. This process is known as fundamental analysis, and is how fund managers, City analysts and the companies team on Investors Chronicle's go about picking likely winning shares.

A good starting point is to read the annual reports to work out how financially strong a company is, and also take time to understand the industry the company operates in, especially how it stacks up against its competitors. After all, good investing is as much about where a company is heading as where it is today. Without access to a crystal ball, fundamental analysis is the best way to work this out.

Nevertheless, the weakness of fundamental analysis is that it is largely backward-looking, based on reported data and shows what happened to a company in the past six or 12 months. That's why it's also important to pay attention to analysts' forecasts. The valuation of a company's shares is always based on what is expected to happen in the next few months or years. That's why having access to analysts' expectations of EPS allows us to see what the PE ratio is for the coming year, and whether the share is good value now, based on what is likely to happen, rather than what has happened in the past.

A good starting point on the share selection journey is to use a stock screening tool – not only does this help you keep your emotions out of investing, but it can also help you wade through vast quantities of financial data. Investors Chronicle's website offers a basic stock-screening tool – and runs tried-and-tested stock screens for inclusion in the magazine each week – but more sophisticated tools are available from providers such as Sharescope, Digital Look and Stockopedia for those who want to build their own custom screens.

Sentiment and shares

Even if you're new to investing, it's likely you'll have heard the expressions 'bull' and 'bear'. In short, a bull is someone who thinks a share or any other asset will rise in price, and a bear the opposite. A bull market, therefore, is a rising one – traditionally defined as a period of several months of rising prices. Sometimes in a bear market you may be tempted to take what's known as a contrarian position – ie, the opposite view to the market direction. This isn't as silly as it sounds – bullishness or bearish sentiment may have pushed a stock too high or low.

It's often tempting to buy a bombed-out share that you think might recover, which can be a very profitable approach if you get it right – as Warren Buffett once said, "be greedy when others are fearful". However, sentiment is a powerful force and it may take the market much longer to recognise a share is over or undervalued than you'd think. "The market can stay irrational longer than you can stay solvent," said John Maynard Keynes – it's certainly wise to remember that no matter how confident you may be in a particular share, if the market isn't you may still lose money.

Follow the leader

You can gain valuable insight into what a company's prospects might be by looking at what those in the know are doing. Nobody is more familiar with a company's prospects than its own directors, so following their buying and selling can be highly profitable. And it's good to know that management have skin in the game – in other words, that their interests are aligned with their shareholders because they're shareholders, too. Watch out, though, for companies with a single dominant shareholder.

Value investing

One of the most popular styles of share investing is something called 'value investing'. Its proponents are looking for companies whose share prices are trading below their so-called intrinsic value, usually defined as the value of a company's assets.

However, because it's hard to value a company's assets, most value investors look for a deep discount as a 'margin of safety'. Value is often to be found at the smaller end of the market, where companies are under-researched – it's a method successfully employed by the IC's stock-picking guru Simon Thompson.

The problem with value investing is that it requires heavy number crunching, which is why its founding father, Ben Graham, eventually gave up on the strategy. However, today's stock screening tools make looking for value shares much easier.

Alternative investments and bonds

What's the alternative?

Alternative asset classes, such as gold and stamps, can be a profitable addition to your portfolios

Many alternative assets have been strong performers over the years, and have often proved resilient during periods of economic weakness when share or bond prices have suffered

Perhaps the central tenet of portfolio allocation is risk diversification. But it has become increasingly difficult for investors to work towards this goal in a low interest economy, where future returns are increasingly susceptible to the vagaries of centralised monetary policy. Although the vast majority of retail investment is focused on shares, there are numerous other asset classes that you can put your money in that fall outside of this mainstream. These are generally known as alternative asset classes.

A key feature of most alternative assets is that they're harder to trade than shares. In other words, they're less liquid, so it's more difficult to add them to an investment portfolio, more difficult to gauge their value, and more difficult to sell them. This is especially true of stamps, art and antiques. However, many alternative assets have been strong performers over the years, and have often proved resilient during periods of economic weakness when share or bond prices have suffered.

The fact that returns on many of these asset classes are non-correlated to conventional equities is certainly worth noting, particularly as cyclical patterns which have previously governed certain sectors have broken down in the wake of quantitative easing (QE) programmes.

Many investors include a defined proportion of higher-risk stocks within their portfolio mix, but are reluctant to move into areas outside their comfort zone. While we generally advocate a cautious mindset in all investment matters, it is also true that improved access to specialist advice, together with the proliferation of derivative trading instruments, mean that a foray into the world of alternative assets is no longer quite such a daunting prospect for the private investor. Indeed, some would argue that alternatives should now be accepted as essential components of a broadly diversified portfolio.

Gold

An obvious example of this is the ease by which retail investors were able to take up long positions on the gold price through exchange traded funds (ETFs) as the US Federal Reserve's QE programmes gathered momentum. Taking an online position in a physically-backed instrument is certainly quicker and more convenient than lugging around a purse full of krugerrands, but ETF investors needn't confine their attention to the precious metals market. ETF providers such as Lyxor and iShares offer a range of liquid contracts that offer indirect exposure to areas such as real estate, private equity, infrastructure and commodities. However, a small holding of gold is often recommended as useful portfolio insurance, given its properties as a store of value.

Property

Recent research from Morgan Stanley suggests that the wealthiest tier in society view real estate as the top alternative asset class to own this year. About three-quarters of private investors with at least £600m in investible capital have turned to a rebounding real estate market as fixed-income yields remain historically low, according to the investment bank's wealth management unit. Direct ownership of residential and commercial properties was the leading investment option for 2014, although investors without access to large amounts of capital can always opt for real estate investment trusts (Reits), or the aforementioned ETFs.

Private equity

From an investment perspective, private equity generally refers to equity-backed finance that is designed to bring about some sort of change in a private business.

Alternative investments and bonds

It's a controversial area insofar as private equity companies such as Carlyle and KKR are regularly criticised for taking a short-term view of their investments, often to the cost of minority shareholders in a given company. Consequently, you might be somewhat reluctant to invest in a public company that is backed by private equity, but you can always profit through the sector itself, by investing in a private equity fund of funds. These offer a broad-based, cost-effective diversification into multiple investments through a single portfolio.

Rarities

If you're looking to buy into the market for antiquities and rarities it's obviously essential to source the best advice available – or perhaps that money can buy. Achieving a nominal rate of return, or even preserving one's capital in specialist esoteric areas such as the art market can be problematic due to issues linked to liquidity and price discovery.

Acquiring collectible art and antiques can be effective investments for people who can afford to set money aside for the long term. These investments are, however, very illiquid – you are unlikely to be able to buy one week, and then sell, next week. You will undoubtedly come across anecdotal evidence about pieces bought at auction that have been subsequently revalued at a huge premium to the sale price, but you couldn't ever base an investment strategy around these one-off gains.

Admittedly, the Mei Moses All Art Index, which is the closest thing we have to a benchmark in the art market, has outperformed the S&P 500 on a total return basis since the onset of the financial crisis, but the index is based on a relatively limited number of high-end transactions that take place mainly in the London and New York auction houses.

Oddly enough, in Britain many private investors are actually more at home with alternative investments when they take the form of stamps or coins. Most philatelists (or more accurately, stamp investors) will know that only a minuscule proportion of the 500,000 or so stamps that have been issued since 1840 are considered to be of investment grade.

But if you choose wisely, there is no doubt that there are advantages on offer. For example, Stanley Gibbons' GB Rarities index, which is comprised of the UK's top 30 rare stamps, has grown by a compound figure of 236 per cent over the past 10 years. That represents an annual increase of 12.2 per cent. But unless you are a genuine expert, taking a punt on markets such as this can be risky. That's why Stanley Gibbons and some other dealers are willing to put together portfolios for would-be investors – and this can be a good first step.

Get to grips with bonds

Aside from investing in a company's shares – or its equity – you can also invest in its debt. The most common way to do this is by buying its bonds. Bonds offer a promise to pay a fixed level of annual interest via a set coupon, and if held to maturity investors are returned 100 per cent of their capital. They are also known as fixed-income investments.

A bond is generally referred to by its issuer, coupon and maturity value. A bond issued by Tesco with a coupon of 6.5 per cent maturing on 11 July 2015, would be known as the 'Tesco 6.5% July 15'. The yield equals the coupon divided by the price of the bond. At issue this matches the coupon, but as bond prices move from par – usually a nominal 100p – so will the yield. If the Tesco bond moves to 107p, the yield will fall to 6.1 per cent, and the bond will be said to be trading above par.

But while most asset allocation models suggest you should have some form of exposure to bonds, for the private investor achieving this hasn't always been easy. Most corporate bonds, for example, are issued via the wholesale market, and can only be traded in very large minimum denominations, which puts them out of reach of all but the very wealthiest and sophisticated of private investors. Minimum denominations of Eurobonds, one of the commonest forms of wholesale bonds, average around €50,000-€100,000.

However, this all changed in 2010 with the launch of the Order Book for Retail Bonds (Orb) by the London Stock Exchange, which allows bonds to be bought at a theoretical minimum denomination of £1 and traded on the secondary market. As they're usually issued by smaller companies, retail bonds generally have a higher coupon than those issued by blue-chip companies; otherwise known as investment-grade bonds, which come with a higher credit rating. Any Orb bond with a duration greater than five years can be held in an Isa.

It's also possible to buy and sell UK government bonds through the Orb market. Otherwise known as gilts, they offer an extremely secure investment, with income and return of capital guaranteed by the British government. You can buy them in varying durations, which offer varying levels of coupon. All Orb prices can be found on the IC website.

Don't confuse Orb-traded bonds with minibonds, which are also sometimes confusingly called retail bonds. These are untradeable, and can't be included in Isas whatever the duration (although some can be held in Sipps). Although they often carry higher coupons, there are fewer regulations around their issuance, which adds up to higher risk. However, all bonds carry risk – one is company default, so you need to understand what assets a bond is secured against and where you rank in the hierarchy of creditors. The trajectory of inflation and interest rates is also important – if these rise, fixed coupons begin to look less attractive and bond prices can fall.

Buy into bond funds

If you want bond exposure but don't fancy taking your chances through an individual Orb, there are plenty of collective vehicles that invest in bonds. This may be a better way for retail investors to gain a suitable allocation to bonds, as fund managers will be able to access a much greater range of bonds otherwise out of reach, and will be constantly shifting portfolios to manage bonds' maturities and interest rate exposures.

236%

The amount the UK's top 30 rare stamps have risen in value over the past 10 years

Emerging markets

Broaden your horizons

Investors should consider allocating part of their portfolios to faster growing, higher risk developing markets

There's a whole world of investment opportunities outside the backyard of the UK, US and Europe. It's easy to stick to markets we know, that are close to home and heart. But the world also offers plenty of thriving, fast-growing developing markets and it makes sense to include some of these in your portfolio as growth rates in developing countries can and do outstrip those of the western world.

The case for emerging markets is as follows: while western economies struggle to claw themselves out of the doldrums with overleveraged economies, banks and households, the world's emerging markets boast robust economies, companies and consumers.

With positive demographics and low debt, the consensus is that emerging markets will be the main growth drivers of the world over the coming years as their economies expand, and millions more fall into the middle class net and become consumers.

China is the classic example of this – its GDP growth has been galloping away at a high rate for years as it undergoes a massive social and economic transformation.

Some seasoned investors such as Jim Rogers, the co-founder of the legendary Quantum Fund with George Soros, think the west's time is over and that you should allocate all your investment fire-power to the emerging powers of Asia. That's definitely not a course of action we'd recommend: emerging markets are high risk. They can be hard hit when there is a wider market sell-off. They tend to be more volatile and less liquid than developed markets. There is a currency risk. You get lower corporate governance than from developed economies.

Emerging markets haven't been shining recently, either. The MSCI EM index delivered a miserable total return of minus 13 per cent between May 2011 and January 2014, while the MSCI World index has surged by more than 27 per cent. And there's a big risk that this rotten run will continue. In addition, there's no guarantee that a developing country will actually cross the divide between being a 'developing' economy and a 'developed' one.

So, the question is how much of your assets should you allocate to emerging markets and in what way? Any diversified asset allocation strategy would suggest some exposure to emerging markets. But how much you should hold in emerging markets depends on a number of factors – the most important being risk appetite. The more cautious you are, the lower your exposure to emerging markets should be.

Emerging markets funds can bring welcome balance to a portfolio as they tend to be less correlated to markets such as the UK, to which many investors already have high exposure.

Advisers generally suggest an allocation to emerging markets of up to 15 per cent of your overall portfolio. As a rough guide, cautious investors should have an allocation of up to 5 per cent, balanced investors between 5 per cent and 10 per cent and adventurous investors between 10 per cent and 15 per cent.

Funds for new frontiers

Certainly, the easiest way to gain general exposure to emerging markets is to allow someone better qualified to invest on your behalf. There are dozens of emerging markets investment funds and trusts, many of which boast fund managers who have been investing in emerging markets for many years. For example, Dr Mark Mobius has spent more than 20 years at the helm of his Templeton investment trust and 40 years investing in emerging markets.

If you want exposure to one particular country or region there are also plenty of funds available.

Investors who prefer using ETFs can access a wealth of different emerging markets products from generic index trackers, which follow the MSCI Emerging Markets index, to country trackers and hybrids such as 'Chindia' trackers and even products that track emerging markets infrastructure investment.

Almost certainly your first move should be into a highly-diversified global emerging markets fund. You should be aiming to take at least a five-year view, and preferably longer.

A snapshot of Brics versus the developed world

	Brazil	Russia	India	China	UK	US
Population under 15 (%)	25	15	30	19	18	20
Urban population (%)	86	75	33	56	80	83
Cars per 1,000 people	136	188	15	18	500	447
Average annual % increase in real GDP 2004-10	4.4	4.6	8.6	11.1	1.2	1.5

Monitoring investments

Keep an eye on your portfolio

It's worth staying on top of your investments but remember you're playing the long game

Once you've built your portfolio you need to make sure it's doing what you want it to. That doesn't mean you need to check it every day – if you've built your portfolio sensibly, it's likely to be able to deliver the returns you expect without much intervention. According to Patrick Connolly at wealth manager Chase de Vere, you should review your investments every six months, and ask three main questions: is it performing as I expected and, if not, why not? How is it performing compared with other investments, and why? And will the performance change so will I therefore need to make any changes?

There are three main aspects to portfolio management: maintaining your required asset allocation, monitoring the underlying investments, and monitoring the overall performance of your portfolio. Your broker may be able to provide you with some free tools to help you do this, but if you've bought investments through different providers you'll need some way to centrally keep an eye on your holdings. In fact, good record keeping is absolutely key to making sure your portfolio is in good shape.

Of these, the most important – but also most frequently forgotten – aspect of portfolio management is rebalancing. Put simply, this means adjusting your holdings so that you maintain the exposures your asset allocation strategy requires. A particularly successful investment in bonds, for example, may mean your exposure there is now too high, and it's time to take some profits. And if you're thinking about making a new investment, you need to understand how it will affect the risk profile and asset balance of your whole portfolio.

You do need to keep an eye on your holdings, too. Companies evolve over time, so it's always worth reading the latest results announcement to make sure it's still operating the same strategy you bought into – if a company has gone way off course, it may be time to sell. Alternatively, you might want to take some profits – or top-slice – on a successful investment.

Whatever the case, it's worth setting up alerts to notify you when there's been a significant news update or price move, or even to see if brokers have changed their forecasts, price targets and recommendations. If you're buying shares of investment trusts, it's also worth setting up watchlists of potential investments. However, it is possible to spend too much time keeping tabs on your investments – doing so can lull you into making unnecessary trades, which can become expensive if you overtrade or panic buy and sell. Remember that investing is a long-term game.

Useful benchmarks

Asset class	Index	What it tracks
Shares	FTSE All-Share	Over 90 per cent of the UK stock market (ex Aim)
Gilts	FTSE UK All Stocks Gilt	Gilts of all maturities other than index-linked
Corporate bonds	Markit iBoxx £ Liquid Corporates long-dated	Investment grade, sterling-denominated corporate bonds
Property	FTSE UK Commercial Property	UK commercial property values
Cash	BoE base rate	The Bank of England's base lending rate

Better benchmarking

It's all very well monitoring a portfolio, but how do you know you're doing well? The answer is by benchmarking. Obviously, you'll have your own target for returns, but you need to ensure this is realistic. If you're expecting a portfolio to increase in value by 10 per cent a year, every year, that may be overly ambitious – the real return on equities after inflation, the riskiest asset class, has been a mere 5.3 per cent a year over the last century or so. And that's four times the return on bonds.

However, it's not unreasonable to expect higher returns than this, and many good fund managers do. Many don't, though – you'll often hear that the vast majority of managers underperform their benchmarks. But what are these benchmarks? In the case of fund managers, they're benchmarking themselves against the average performance as measured by the Investment Management Association or, in the case of investment trusts, the Association of Investment Companies. But, internally, they will benchmark themselves against wider indices such as the FTSE All-Share or other equivalent global indices. That's a useful exercise for private investors, too – if you're struggling to beat the performance of an index you might want to consider just using passive tracker products instead. If you want to benchmark the assets in your portfolio, there are a selection of indices in the table you might like to use.

Make the most of tax breaks

Investors should use every tax break available to make their money work harder for them

As an investor, you have to face the risk that you could lose money at any time. This might be because of a failed investment and won't always be something you could have seen coming. But there are two other ways of losing money which you can control to an extent: they are charges – see page 7 for more on this – and taxes.

There are no benefits whatsoever to overpaying tax. It just means your returns are lower and your money will have to work harder than everyone else's. So use every tax break available to you and arrange your affairs as tax efficiently as possible.

Isas and pensions

There are two big tax breaks that every investor and saver should, if they can, take advantage of. They are Isas and pensions. It's a no-brainer that you should have an Isa, even if you're a basic-rate taxpayer. If you save and invest over the long term the tax benefits really add up.

The Isa is easiest to understand because of its simplicity: Isas are tax wrappers into which you can put cash or stocks and shares. Any income received in the form of interest and dividends is free of further tax and there is exemption from capital gains tax on any capital growth. So, in a nutshell, you put your money in and it grows free of tax and you can then take your money out free of tax.

For the 2013-14 tax year, the maximum amount that can be invested into an Isa is £11,520. After 6 April, it rises to £11,880. You can put all of this allowance into stocks and shares. But the limit for cash Isas is half this amount at £5,760 (£5,940 after 6 April). So if you use your full cash Isa allowance, you would then have £5,760 (£5,940) left to invest in stocks and shares.

Pensions, meanwhile, offer generous tax breaks to encourage us to put money away for later life. If you are a basic-rate taxpayer, a pension contribution of £10,000 will only really cost you £8,000 once income tax relief is applied. For a higher-rate taxpayer, the net cost is £6,000. This has the effect of guaranteed instant growth of over 25 per cent for the basic-rate taxpayer and 66 per cent for the higher-rate taxpayer.

Capital gains tax

There are other tax breaks, too. Each year you are allowed to realise up to £10,900-worth (£11,000 from 6 April) of capital gains before you have to pay capital gains tax (charged at a rate of either 18 or 28 per cent depending on your circumstances) so, if you are planning a large sale of shares that have increased in value over a number of years, as the end of the tax year approaches you could split the sale across two tax years. You should also consider your spouse's allowance and register some holdings in his or her name, again to maximise the tax breaks available to you as a couple. You can offset investment losses against cases but there are time limits and other restrictions. A good starting point is http://www.hmrc.gov.uk/cgt/intro/working-basics.htm.

VCTs

For more sophisticated and adventurous investors, venture capital trusts (VCTs) – funds that invest in fledgling but very high-risk small companies – offer juicy tax breaks as long as you stay invested for at least five years. At Investors Chronicle we write a detailed report on this sector each year where we explain the tax breaks in full and comment on all the available opportunities. Visit *www.investorschronicle.co.uk/funds-and-etfs*.

Inheritance tax

If you have assets and a family home and want to pass them on to your children or grandchildren, there's a good chance you will become entangled in the inheritance tax net. Inheritance tax is paid on the value of your estate (after your death) over the (current) threshold of £325,000 at a rate of 40 per cent. You can take simple steps to reduce the amount of tax payable. They include, first and foremost, making a will; making gifts during your lifetime, and transferring a spouse's unused allowance or assets to a spouse.

Tax rates in 2014-15

You can make gains of up to £11,000 free from CGT. On gains over this amount, tax of either 18 per cent or 28 per cent will be payable. The tax rate you use depends on the total amount of your taxable income.

Inheritance tax rates

IHT is charged at 40 per cent on the value of your estate above £325,000.

Everything you leave to a spouse or civil partner will be exempt from inheritance tax If you make a gift to someone other than a spouse, generally the gift will be exempt from inheritance tax after seven years as long as you no longer use or benefit from that asset. For example, you cannot continue to live in a house you have gifted to someone and still gain IHT exemption.

Pension allowances

The maximum amount you can contribute to your pension in a single tax year is £40,000. The maximum amount you can put into your pension over your lifetime is £1.25m. Breach that limit and you will pay hefty tax penalties.

Isas

You can invest up to £11,880 in an Isa, of which up to £5,940 can be held in cash savings.

Income tax

You can earn or make up to £10,000 before you start paying tax. Basic-rate tax is charged at 20 per cent, higher rate at 40 per cent and additional rate at 45 per cent.

Mathematical concepts

The maths of investment

Here are some basic mathematical concepts that underpin any portfolio

You don't have to be a maths genius to be a successful investor, but it pays to have a good grasp of some of the basic mathematical concepts that underpin any portfolio.

Compounding

Einstein is said to have described the principle of compounding as "the eighth wonder of the world. He who understands it, earns it... he who doesn't... pays it". Compounding is certainly one of the most powerful mathematical forces in investing and can really work wonders for your portfolio.

One way to capture the benefits of compounding is by reinvesting your dividends rather than by taking them out as income. In short, you will be accruing income on an ever larger pot, even without capital gains. The same effect can work against you, of course, especially when it comes to charges – paying a fund manager a couple of percentage points a year might not sound like much, but over time the impact on your returns can be astounding.

Here's how it works. Let's say you earn 5 per cent on £100 in a year. At the end you'll have £105. If you take out the £5 as income, the next year you'll only generate another £5 on the initial £100. But if you let the return accrue on the £105, you'll generate £5.25.

Pound cost averaging

It's possible to build up a holding through regular investment than simply in one go. This investing style is known as 'pound cost averaging' and it averages out your returns – some months you will invest at higher prices and some months at lower prices. If you invest the same amount of money each month, when the share price is down you get more for your money than you will when the share price is up. But if the share price keeps rising you will not make as much as if you had invested a lump sum at the outset. However, research shows that in bear markets regular investing beats lump sum investing. See page 8.

Calculating real returns

Let's say your portfolio returns 10 per cent in a year – that's a pretty good performance, right? The answer is, it depends on what's going on with interest rates and inflation, the scourge of any saver.

Today, of course, when interest rates stand at record lows and inflation is falling, 10 per cent would be a magnificent outcome. But go back to the 1970s, when inflation hit 25 per cent, and it wouldn't look so impressive. In that instance, the real rate of return would in fact have been minus 15 per cent, the difference between your absolute return and inflation. This is a key risk all investors should consider, along with some others listed on the right.

Total return

You'll often see the performance of assets cited on a 'total return' basis – this is the aggregation of the capital return (the growth of the asset) and the return from any dividends or similar payments it may make.

Some simple stockpicking tools

■ Earnings per share (EPS). This is the amount of profit 'owned' by each share, and is taken by dividing a company's total net (taxed) profit by the number of shares in issue.

■ Price-earnings ratio (PE). This is the standard measure of value for money when buying shares, and is calculated by dividing the current share price by the annual EPS figure. This gives you the price you paid for each 1p of taxed profit. The faster a company is increasing its profits, the higher a PE ratio it can justify.

■ Dividend yield. This is simply the total dividend divided by the current share price, and measures the return you would get on your invested funds as an annual percentage. A company's ability to pay a dividend is determined by how much cash its business generates in excess of what it needs to fund its day-to-day business.

Understanding risk

Risk comes in many forms – here are a few that investors need to be alert to:

Market risk: Your investment is carried lower on the back of a decline in the market for similar assets. Even the best companies struggle in bear markets.

Inflation risk: Your investments rise in value but not as fast as inflation. A related risk is interest rate risk – if a central bank raises interest rates in response to rising inflation, this can affect the value of interest rate sensitive products such as bonds or high-yielding shares

Asset risk: A specific catastrophe hits the value of your investment, for example a company whose shares or debt you bought goes bust or defaults on its bonds.

Counterparty risk: An intermediary with whom you are dealing becomes insolvent, trapping your investment. While you're protected by the FSCS to some extent, getting your money back can take time and effort.

Spread your wealth

As your pot grows larger it's wise to spread your cash around multiple providers to ensure you don't exceed the government's compensation limits in the extremely rare event that your provider goes bust and your money disappears.

The limits under the Financial Services Compensation Scheme are £50,000 for investments and £85,000 for cash and deposits per provider – so, if you have two bank accounts with two different banks, for example, £170,000 of your cash is protected.

Be a better investor

Avoiding common errors

Here, we look at the most common mistakes made by new and not so new investors, and show you how to avoid them

It's human nature to make mistakes. You will as an investor. What matters is to make yourself aware of the most common slip-ups in order to avoid them, and to be better able to notice when you start slipping into bad habits.

We're not talking merely about buying the wrong share or buying at the wrong time – these mistakes might be down to poor research or plain bad luck. Here you should review your actions to learn from them. But there are other simple and easily avoidable errors that trip investors up time and time again, so let's look at those.

Over exposure to one area

Don't put all your eggs in one basket. Yet it's easy to do: new investments are made without reference to what's already in your portfolio, so you end up with 80 per cent of your money in just one market. Or you add a new fund without checking to see if its largest holdings match what you already hold.

Failure to monitor performance

The best planned portfolios need to be reviewed and rebalanced every so often. It's important to do this because your original allocations will change significantly over time along with shifts in the market. The layout of your portfolio may no longer match your risk profile or your goals.

Having too many holdings, and too many small holdings

This makes it more difficult to administer a portfolio and have a real understanding of how it's performing. Sell or amalgamate small holdings and focus on those investments that are best-placed to achieve your financial objectives.

Not minimising costs

Think of costs as the enemy, and keep a close eye on them at all time. Over five years you can sacrifice thousands by paying too much in fund and dealing charges. See our separate article on charges on page 7.

Not being brave

Following the herd in and out of markets and sectors is likely to lead to losses as you will be buying when prices are rising or already high and selling when they falling or already low. Think about why you bought the investment in the first place. If those reasons are still valid, don't let a short-term blip cost you a small fortune.

Not minimising tax

It's a cliché because it's true; the first rule of investing is not to hand money to the taxman unnecessarily. This doesn't mean investing in fancy tax-dodging investments. It just means taking advantage of the allowances you have.

Forgetting about tracker funds

It's not just the taxman you should avoid giving money to. You should also not hand money over to fund managers without good reason. If you want exposure to equities, your default position should be a low-cost equity tracker fund. Only depart from this if you have good reason to do so.

Not diversifying across assets – including cash

Although you can't easily spread risk by diversifying across shares, you can do so across assets. Over the last 20 years, monthly returns on gilts and gold (in sterling) have had zero correlation with equities, which means that if shares fall there's a 50:50 chance that either gold or gilts will rise.

Correlations, however, vary with macroeconomic conditions. It's possible that these will become positively correlated if or when investors come to fear a serious tightening of monetary policy. One asset that protects you from this correlation risk is cash. Which is one reason why it's worth holding some, even at negative real returns.

Diversifying too much

It's very easy to buy more than sell and to build up a portfolio of dozens of shares over time, and end up with a sprawling mess that is merely an expensive tracker fund.

Use a core-satellite strategy instead. Use a tracker fund to get general exposure to the stock market, and complement this, if you want, with a few specific stock picks.

Over trading

One of the strongest findings in economic research is that people who trade a lot end up poorer for it. One reason for this is that they are overconfident about their ability to pick winners. Another is that we fail to appreciate that a lot of news is just noise, which conveys no signal about future returns

Lacking discipline

What makes a successful investor? According to Lasse Pedersen and colleagues at AQR Capital Management, the answer is discipline. They show that the key to Warren Buffett's success is not so much great stock-picking as the willpower to stick with the strategy of holding defensive, quality stocks even in times when they did badly, such as during the tech bubble. This discipline means he's been able to profit enormously when good long-term principles come back into favour. Finding a few good rules and sticking to them is better than hyperactivity.

Not assessing risks

Pretty much all assets carry risk. You need to assess the risks for each individual investment that you make, and to consider if you are overexposed to one type of risk – for example, that a certain technology will become redundant.

There are also risks to consider that matter more for some people than others. For example, if you're retired and on a flat-rate annuity, inflation risk will matter more to you, while younger people can cope better with the large risk of short-term falls in share prices. So ask: which risks bother me? Hold the assets that protect you from this danger, but not those that protect you from risks that don't trouble you. And remember – there's always a case for holding cash.

Ignoring danger signs or not acting quickly when trouble shows

The real key to preserving your capital actually lies in acting decisively when it is clear that a company whose shares you own is in trouble. Otherwise known as falling in love with a share and giving it chance after chance. The humble stop-loss, whether it is a mental rule of thumb or a preset trade stored in an internet stockbroking account, can be a real life saver. Danger signs include profit warnings and high and rising debt.