Understanding asset types and sectors

Main asset types and associated risks

‘Asset’ is simply the name used to describe anything of value that somebody can own. For investments it is used to describe the four main types of asset that can be bought; cash, bonds, property and equities.

Investment risk is quite a complicated area but is basically the risk that you might not get back the amount that you invested.

Investment risk is always present; even money held in a normal bank account carries the risk that inflation (the cost of goods and services rising) will mean that your money may have a lower buying power in the future (the same amount of money in the future will not be able to buy the same amount of goods that it could today).

To make sure that your money today will still have the same value in the future, it will need to grow by at least as much as the rate of inflation. For your money to be worth more in the future than it is today, it will have to outgrow inflation and this usually means accepting a higher level of risk. Generally speaking the types of assets that have higher potential for growth usually come with a higher level of investment risk. Working out your attitude to risk is important and your adviser will be able to help you.

Many types of asset can be bought directly from a stockbroker, but using an investment fund can be attractive as it pools your money with many other investors and allows fund managers to buy assets in many more companies than most individuals would be able to do on their own.

Cash

Cash as an asset class generally refers to deposits with banks and institutions which then pay interest on those deposits. This is the lowest risk asset class, but this means that returns are generally lower over the medium to long term (five years and over) than other asset classes.

Cash is not completely without risk as in the unlikely event of a bank or institution failing losses could be incurred. The risks can be reduced by investing with a number of financially strong deposit-taking institutions. The term ‘cash’ is also taken by some fund managers to include low risk assets that are similar to cash such as Certificates of Deposit (a fixed term deposit usually with a fixed rate of interest payable) and Treasury Bills (short term government bonds) and commercial paper (a short term debt instrument issued by a company). Because fund managers can use a wide range of cash and cash-type assets they can potentially generate better returns than a standard high street bank account is able to achieve.

As already mentioned, for a cash based investment to grow it needs to attract a return that is more than the current rate of inflation.

Bonds or fixed-interest and index-linked securities

‘Bonds’ tend to be the catch-all word used to describe this type of asset, but you may also see funds talking about ‘fixed interest’ or ‘fixed income’ and ‘index linked securities’ which all mean roughly the same thing.

In simple terms a bond is a loan from an investor to a government or a company which is looking to raise money, often for a particular project:

- **Government bonds** – these are issued by governments around the world to raise funds for major projects, such as a hospital building programme or a new rail route. Bonds issued by the UK Government are called ‘gilts’ (sometimes referred to as sovereign bonds).
- **Corporate bonds** – these are issued by UK and international companies as a way to raise money for reasons such as investment, expansion and research.
- **Index-linked securities** - An index-linked bond, or inflation-linked bond, is an investment that promises to pay you an inflation-linked return. There are several different types of index-linked bonds on offer but the best known in the UK is the index-linked government bond or ‘gilt’ which tracks movements in the retail price index (RPI) – a measure of inflation.

How bonds work

- A government or company (the ‘issuer’) will create a series of bonds for the amount of money they want to raise.
- The bonds will usually have a fixed end date in the future, often called the ‘redemption’ or ‘maturity’ date.
- The bonds are issued at a fixed price called the ‘face’ or ‘par value’ which is usually £100. This is the value that the issuer promises to repay to the holder of the bond at the maturity date.
- To make investors want to buy bonds, the issuer has to offer to make regular interest payments to the holder of the bond. The interest rate is called the ‘coupon’ and is worked out as a monetary value. For example a £100 bond with a 4% coupon would make an interest payment of £4 interest a year; this payment value is usually fixed for the life of the bond. The ongoing value of the interest payment is called the ‘yield’.
- The investor who buys the bond doesn’t have to keep it until the maturity date; bonds can be bought and sold on the open market.
- Although the face value of the bond is set when they are first sold, the price for buying and selling them after they’ve been issued can change. Factors such as interest rates, inflation and how well the issuing government or company is perceived can all affect prices.
- Index-linked gilts are different from standard gilts because both your coupon and redemption payments are linked to inflation.

Changes in bond prices

Putting it simply, when interest rates rise, bond prices fall and yields go up. And when interest rates fall, bond prices go up and yields fall.

This sounds odd but happens because when interest rates rise they will be closer to (or maybe higher than) the coupon of existing bonds which makes them look less attractive as investors may be able to get a better return elsewhere. This usually means that demand, and therefore price, goes down and the yield goes up.

When interest rates fall the coupon on existing bonds look more attractive so demand (and price) goes up and yields go down.

This is best shown as an example:

- A bond is issued with a face value of £100 and a coupon of 4%, making the annual interest payment £4 (£100 x 4%)
- Interest rates rise so demand goes down and the bond price falls to £50. The interest payment doesn’t change (still £4) so the yield rises to 8% (£4 divided by £50).
- Interest rates fall so demand goes up and the bond price rises to £160. The interest payment doesn’t change (still £4) so the yield falls to 2.5% (£4 divided by £160).

Inflation also has a big affect on bond prices. If a bond’s yield is 5% and inflation is 2% then the real return on the bond is 3% (5% – 2%). Falling and low inflation is usually good for bond investors.

Supply and demand will influence bond prices as well; if the government wants to raise lots of money and issues lots of new bonds, then the increased supply usually means investors will not want to pay as much for them, so prices fall. If new bonds stop being issued, the reduced supply usually means prices will increase.

Another factor which has affected the price of bonds in recent years is quantitative easing, commonly referred to as “QE”. This is the process whereby central banks, such as the Bank of England, buys bonds in the market from investors. This reduces the supply of bonds and can reduce interest rates and therefore push bond prices higher.

Specialist agencies review the financial strength of the companies and governments that issue bonds and consider their ability to repay loans at maturity. The agency then gives a rating to the issuer which helps the market understand how good their bonds are. Typically the bonds with higher ratings are in higher demand and can offer a lower interest rate than weaker bonds with poorer ratings which need to offer a higher interest rate to create demand.

UK gilts are generally seen as safe as the repayments are guaranteed by the UK government. Overseas government bonds may be somewhat less safe, depending on the risks associated with the particular issuing country; some are very safe but others can carry higher levels of risk and in addition there may be some risk from holding bonds in foreign currencies as exchange rates move up and down. Corporate bonds are generally regarded as carrying more investment risk than government bonds.

Generally speaking, fixed interest securities are regarded as lower risk than equities and property, but prices can move up and down on a daily basis and there is a risk that you could get back less than you invested.

Property

Property as an asset class generally refers to direct investment in commercial property; an investment fund will actually purchase a building. The term 'commercial property' can include offices, shops, industrial units, leisure parks and retail warehouses. Investors in commercial property are generally looking to achieve a total return from rising property prices and from rental income. Property can also refer to investments in, or vehicles investing in, residential property.

In addition to direct property holdings, some property funds may also invest in the shares of property investment companies in the UK and/or in foreign markets.

Property as an asset class tends to have low volatility as prices tend to move up and down gradually, although there can be exceptions to this, and it is generally regarded as having a lower investment risk than equities but more than cash and fixed income.

In addition to market risk, another risk involved in investing in property is that property is not easy to sell which means you may not be able to cash in your investment when you want and there may be a delay (some of these delays may be significant in duration and can be up to six months). The value of property is generally a matter of a valuer's opinion rather than fact.

In extreme circumstances, such as following the result of the EU referendum, Market Value Adjustments may be applied to the value of properties as a temporary measure. These adjustments to values are based on the best estimates that an event could have on property values and are applied to protect existing investors in a fund.

Funds which invest into the shares of property companies can behave more like a normal equity fund and are seen as having more investment risk than a direct property fund.

Costs of buying and selling real property are generally much higher than for other types of assets. Property investments may be subject to significantly wider price spreads than bonds and equities which could affect the valuation of the fund by up to 8.00%.

Equities

Shares, (often called equities or stocks), provide an ownership interest in companies and are usually listed on a stock exchange. Investors in equities are looking to achieve capital growth from rising share prices and, in many cases, also a share of profits through dividend distributions. Dividend is the term used to describe the amount of profit that a company decides to pay out to its shareholders.

Over the long term equities have historically mainly provided better returns than cash, bonds and property. However, share prices can move up and down on a daily basis and can change suddenly, and sometimes very sharply, meaning that of the four main asset classes equities are generally considered to have the highest level of investment risk.

International equities are generally regarded as higher risk than UK equities because in some countries share price movements have been more extreme, both up and down, and there is also the increased risk from currency exposure. However, the inclusion of international equities may provide investors with a valuable measure of geographic and economic diversity. As an asset class, equities are regarded as being riskier than cash, fixed income and property.

Equities are a very broad category of asset and contain a range of sub-groups, each of which have their own characteristics, some based on the type of company they invest in, and others based on a particular region of the world. Some of the most common sub-groups used within fund descriptions include:

- **Large cap**; some funds only invest in shares of the companies with the largest market capitalizations.
- **Smaller companies**; funds may only invest in shares of the smallest companies listed on a stock exchange.
- **Opportunities or recovery**; a fund might focus only on shares in companies which are often new or recovering from a bad period.
- **Sector specific funds**; some funds focus on companies in certain sectors, such as commodity and energy or technology.
- **UK**; of the many funds available in the UK, a substantial number of them invest in companies quoted on the UK stock markets. However, a large portion of these companies' earnings can come from overseas.

- **Developed regions**; many funds invest into a particular developed market or region overseas such as Europe, North America, Japan and Asia.
- **Emerging markets**; beyond the developed economies of the world there are many countries and markets which are still developing (or 'emerging'), such as China, India, eastern Europe and Latin America. Funds investing in these areas often carry a greater degree of investment risk but can also provide greater opportunities for growth.

One further consideration to bear in mind is currency or exchange rate risk. Where funds purchase assets held in currencies other than sterling, there will need to be some mechanism for converting the value and income back to sterling for the UK investor. Exchange rates are constantly moving and depending on which way they are moving, they can help or hinder a fund. Funds may or may not use a process called hedging to reduce the impact of movements in exchange rates.

ABI sectors

With an understanding of the four main asset classes, it becomes much easier to understand the sorts of investment risk that a fund might contain. For example, you can see that a fund with a high equity content will have a greater investment risk than a fund holding mostly cash. However, it can still be difficult to compare funds as it isn't always clear what sort of assets a fund invests into.

To help you compare similar funds we group the funds we offer into sectors. The sectors we use are created and controlled by the Association of British Insurers (ABI), who aim to ensure that all of the funds within a particular category are broadly comparable, making it easier for investors to compare like with like when deciding which fund is most suitable for them.

The sectors are gathered into six groups and the criteria for each of the sectors are set out below. In general terms the sectors are defined by a variety of factors including equity content, spread and type of assets, geography (where funds are invested) and currency. A fund must comply with the criteria set out in order for it to remain classified within that category.

Importantly, the categories are not specifically designed to 'risk grade' funds, but to group together funds which are similar, so that they may be more easily compared.

This guide lists the sectors in which we have funds available to select and the descriptions have been taken from the ABI website. Additional notes to the definitions are available at **www.abi.org.uk**

Mixed Asset Fund Sectors

Mixed Investment 0 – 35% Shares

Funds in this sector are required to have a range of different investments. Up to 35% of the fund can be invested in company shares (equities). At least 45% of the fund must be in fixed income investments (for example, corporate and government bonds) and/or cash investments. Cash can include investments such as current account cash, short-term fixed income investments and certificates of deposit.

- Maximum 35% equity exposure
- No minimum equity requirement
- Minimum 45% investment grade fixed income and cash
- Minimum 80% investment in established market currencies (US Dollar, sterling & euro) of which 40% must be sterling
- Sterling requirement includes assets hedged back to sterling

Mixed Investment 20 – 60% Shares

Funds in this sector are required to have a range of different investments. The fund must have between 20% and 60% invested in company shares (equities). At least 30% of the fund must be in fixed income investments (for example, corporate and government bonds) and/or cash investments. Cash can include investments such as current account cash, short-term fixed income investments and certificates of deposit.

- Maximum 60% equity exposure
- Minimum 20% equity exposure
- Minimum 30% fixed income and cash
- Minimum 60% investment in established market currencies (US Dollar, sterling and euro) of which 30% must be sterling
- Sterling requirement includes assets hedged back to sterling

Mixed Investment 40 – 85% Shares
Funds in this sector are required to have a range of different investments. However, there is scope for funds to have a high proportion in company shares (equities). The fund must have between 40% and 85% invested in company shares.

- Maximum 85% equity exposure
- Minimum 40% equity exposure
- No minimum fixed income or cash requirement
- Minimum 50% investment in established market currencies (US Dollar, sterling and euro) of which 25% must be sterling
- Sterling requirement includes assets hedged back to sterling

Flexible Investment
The funds in this sector are expected to have a range of different investments. However, the fund manager has significant flexibility over what to invest in. There is no minimum or maximum requirement for investment in company shares (equities) and there is scope for funds to have a high proportion of shares. The manager has a significant degree of discretion over asset allocation and is allowed to invest up to 100% in equities.

- No minimum equity requirement
- No minimum fixed income or cash requirement
- No minimum currency requirement

UK Equity Fund Sectors

UK All Companies
Funds which invest at least 80% of their assets in equities quoted on the UK stock market and have a primary objective of achieving capital growth or total return.

UK Smaller Companies
Funds which invest at least 80% of their assets in equities quoted on the UK stock market which form the bottom 10% by market capitalisation.

UK Equity Income
Funds which invest at least 80% of their assets in equities quoted on the UK stock market. The yield (net of tax) on the underlying portfolio must be at least 110% of the FTSE All Share yield.

Note: it is not normally possible to derive income from life and pension funds as they are not income-generating assets. However, there is clearly a distinct style evident in funds invested in this way and the parameters for the UK Equity Income sector aim to group these in a comparable way.

Overseas Equities Sectors

Europe excluding UK Equities
Funds which invest at least 80% of their assets in equities quoted on European stock markets, but which normally hold no equities quoted on the UK stock market. Europe includes all countries in the FTSE World Europe/MSCI Europe indices.

North America Equities
Funds which invest at least 80% of their assets in equities quoted on United States and Canadian stock markets.

Asia Pacific excluding Japan Equities
Funds which invest at least 80% of their assets in Asia Pacific equities, but which normally hold no equities quoted on the Japanese stock market. Asia Pacific includes all countries in the FTSE World Asia Pacific index.

Japan Equities
Funds which invest at least 80% of their assets in equities quoted on the Japanese stock market.

Global Equities
Funds which invest at least 80% of their assets in equities and must be invested in more than one equity region. The sector does not include funds which would otherwise qualify for the Global Emerging Markets Equity sector.

Global Emerging Markets Equities
Funds which invest at least 80% of their assets in equities from emerging markets, as defined by the FTSE World Index Indices, without geographical restriction.

Fixed Interest Sectors

UK Gilts
Funds invest at least 95% of their assets in UK government securities (Gilts), UK government backed securities and sterling denominated (or hedged back to sterling) AAA rated, overseas government backed securities. At least 80% of the fund must be invested in UK government securities (Gilts).

UK Index-linked Gilts
Funds which invest at least 95% of their assets in UK government Index Linked securities (Index Linked Gilts), UK government backed Index Linked securities and sterling denominated (or hedged back to Sterling) AAA rated, overseas government backed Index Linked securities. At least 80% of the fund must be invested in UK Index Linked government securities (Index Linked Gilts).

Sterling Fixed Interest
Funds which invest at least 80% of their assets in sterling-denominated (or hedged back to sterling) broad investment grade fixed interest securities.

Sterling Strategic Bond
Funds with an investment policy which allows for significant changes in asset allocation between broad investment grade and sub-investment grade securities. Funds must invest at least 80% of their assets in sterling-denominated (or hedged back to sterling) fixed interest securities.

Sterling Corporate Bond
Funds which invest at least 80% of their assets in sterling-denominated (or hedged back to sterling) broad investment grade corporate bond securities.

Global Fixed Interest
Funds which invest at least 80% of their assets in non-UK broad investment grade fixed interest securities.

Sterling High Yield
Funds which invest at least 80% of their assets in sterling-denominated (or hedged back to sterling) fixed interest securities. Funds which invest at least 50% of their assets in sub investment grade fixed interest securities.

Global High Yield
Funds which invest at least 80% of their assets in non-UK fixed interest securities.

Funds which invest at least 50% of their assets in sub investment grade and/or emerging market fixed interest securities, without geographical restriction.

Property

UK Direct Property
Funds that normally invest at least 80% of their assets in UK property. Managers may occasionally use Property Index Certificates or other property instruments for up to 20% property investment. UK property is defined as real estate located within the UK.

Global Property
Funds that invest at least 80% of their assets in direct property and property securities. A minimum of 50% must be held in non-UK assets.

Other fund sectors

Money market
Funds in this sector must meet the following conditions:

- The primary investment objective of the fund is to maintain capital and aim to provide a return in line with money market rates, before charges.
- Invest at least 95% of the fund in Sterling (or hedged back to Sterling) money market instruments.

Further details on what constitutes permitted money market instruments is available from the ABI website **www.abi.org.uk**

Protected/Guaranteed Funds
Funds, other than money market funds, which principally aim to provide a return of a set amount of capital back to the investor (either explicitly guaranteed or via an investment strategy highly likely to achieve this objective) plus some market upside.

Commodity/Energy
Funds that invest at least 80% of their assets in commodity and/or energy related securities.

Specialist
Funds that have an investment universe that is not accommodated by any of the other ABI sectors. As funds in this sector do not meet any pre-set parameters, these should not be compared on a like-for-like basis.

Other useful guides

If you would like to know more about investments and the sorts of funds that we offer, then we have a range of other guides that might be of interest to you;

Understanding diversification,
document number MKT580
This guide explains what diversification is and why it can be useful to invest into different sorts of assets and funds.

Understanding volatility,
document number MKT581
A guide to what volatility is, how we measure it using standard deviation and how it can help in understanding how a fund might behave.

Fund volatility and performance,
document number MKT582
Details on the range of funds that we offer access to including information on past performance and volatility.

Guide to fund factsheets,
document number MKT611
A guide to help explain the headings and descriptions used in our fund factsheets.

Monthly performance update and fund charges
Every month we publish updated performance data over various time periods.

Life Series 3 funds
(reference ID6778)

Life Series 4 funds
(reference ID6779)

Life Series 5 funds
(reference ID6780)

Pension Series 4 funds
(reference ID6781)

Pension Series 5 funds
(reference ID6792)

Old Canada Life funds
(reference ID6784)

Manulife funds
(reference ID6783)

Albany Life funds
(reference ID6782)

All these documents are available on our website **www.canadalife.co.uk** or by calling us on **0345 6060 708**.

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