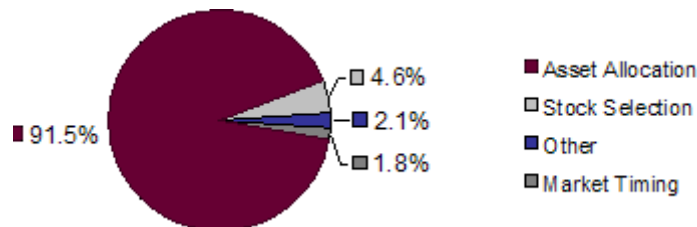




THE IMPORTANCE OF ASSET ALLOCATION

Once the decision has been made to invest in equities and that the investment should be in index funds, the next step is to ensure that the overall structure of your portfolio is appropriate.

The landmark study, *Determinants of Portfolio Performance*, published in the *Financial Analysts Journal* in 1986 suggested that well over 90% of investment performance is derived from asset allocation decisions, not market timing or stock selection. These findings were confirmed in the follow up study by Brinson, Beebower and Singer in 1991, and numerous subsequent academic studies have reached similar conclusions.



Source: Brinson, Singer, Beebower, 1991

Further studies by Ibbotson Associates et al 2000 also showed that 91% of investment returns were derived from asset allocation, where stock selection only delivered 5% of returns, market timing 2% and other factors 2%.

The importance of asset allocation is reinforced by the Myners Report of March 2001 into institutional investment in the UK, commissioned by the Chancellor of the Exchequer. Part of the review defined best practice codes for pension fund decision-making, one of which stated:

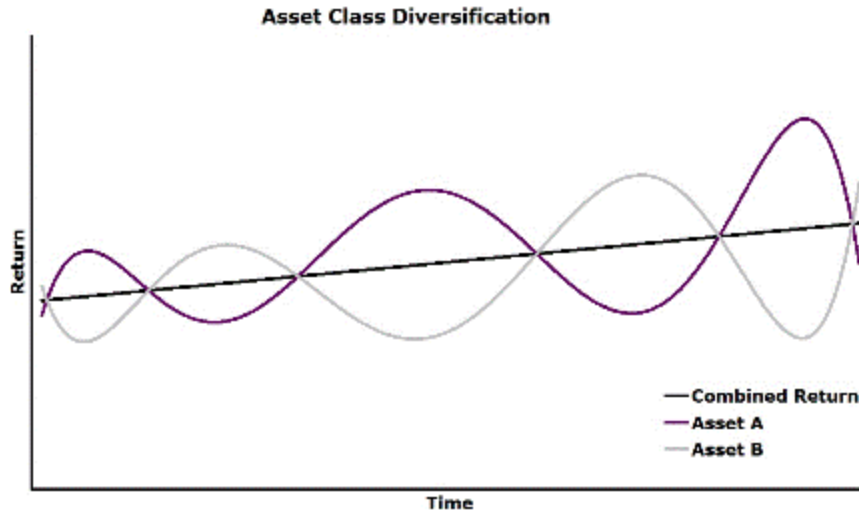
“The attention devoted to asset allocation decisions should fully reflect the contribution they can make to achieving the fund’s investment objective”.

It is now generally accepted that strategic asset allocation is by far the most important determinant of portfolio performance. This is the process of allocating your capital across a range of different asset classes, such as cash, fixed interest, property and equities. This is not simply a question of diversification, although spreading risk amongst different asset classes is clearly important. The optimum split between these asset classes depends on your personal objectives for the portfolio and on the risk of failure that you are prepared to take over your chosen timescale.





The effect of diversification can be shown by the following graph:



The graph shows that holding two assets which are not positively correlated smooths the overall return of the investor.

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