



Our Investment Philosophy

“The uniform, constant and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement”

Adam Smith, ‘The Wealth of Nations’, 1778

Over centuries, human endeavours have combined to propel economic growth. Today, there exist opportunities to participate in various areas of the economy, through investment in a range of asset classes, each of which has a different risk/return profile.

Cash deposits are effectively loans to financial institutions such as banks or building societies. They offer very little risk to the capital value (unless the institution collapses), but inflation can erode the real value of the capital over time and reduce its buying power.

Bonds are loans to governments (gilts) or companies (corporate bonds), with terms that can range from a few months to indefinite periods. The interest rates are usually fixed, so the capital values of the bonds vary in line with interest rates generally, to bring their yields back into line with the market. Index-linked bonds can guarantee a positive return against inflation between issue and redemption, however long-term protection against inflation is more usually provided by asset-backed investments, such as equities or property.

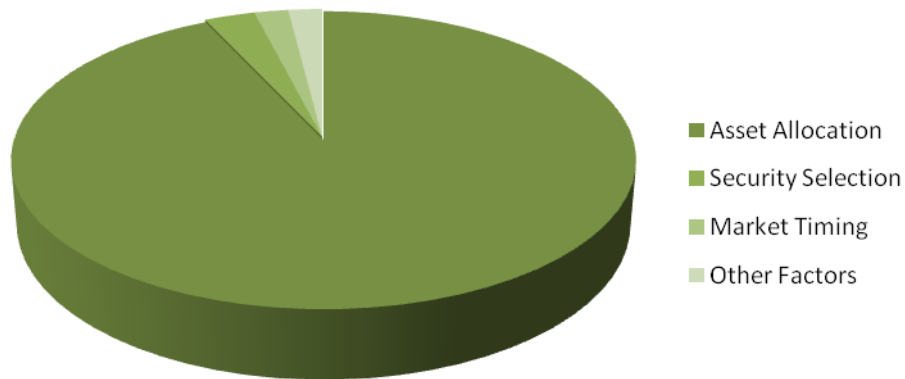
Equities are shares in companies, the profits of which are in part distributed to shareholders as dividends. The value of the shares depends on the expectation of future profits and how they will be distributed. Underlying the general rise in share prices is the widespread increase in industrial productivity and thus prosperity, although interruptions can be substantial and prolonged, as in the 1940s and 1970s. Equity investments are characterised by insecurity of income and capital values over the shorter term, but offering the potential of rising income and real capital growth over the long term.

Alternative investments such as property and commodities have proved to be reasonable long-term hedges against inflation. They can also reduce volatility in a portfolio, as their cycles do not necessarily follow the equity cycle.

The importance of asset allocation

It is widely accepted that the way in which a portfolio is allocated to these assets is by far the most important factor that will influence its performance. Various academic studies have agreed that asset allocation accounts for over 90% of results, making it more than ten times more important than market timing and security selection (stock-picking) combined.

The relative importance of factors influencing portfolio performance



Source: Brinson, Hood & Beebower 'Journal of Finance', November 1986

Not only is asset allocation by far the most important factor to consider when constructing a portfolio, it is also the only one that can be positively influenced, as market timing and proficient security selection are notoriously difficult to achieve.

The difficulties with market timing and security selection

Market timing is particularly difficult to perfect because sharp rises and falls in markets tend to be concentrated in short periods. The following table shows how, in the 22 years to January 2007, missing just a few of the days in which equities performed best, would have severely diminished annual returns. Nobel Laureate William Sharpe calculated that investors would have to make correct timing decisions 82% of the time to beat a portfolio that remained fully invested. As the world's most successful investor, Warren Buffet, said "It's *time in* the market, not *timing* the market that counts".

		Stayed fully invested	Best 10 days missed	Best 20 days missed	Best 30 days missed	Best 40 days missed
UK	FTSE 100	10.2%	7.1%	4.6%	2.8%	1.1%
International	MSCI World	9.3%	6.7%	4.6%	3.1%	1.6%

Average annual returns to 31/01/07. Source: UBS Wealth Management

The selection of individual securities such as stocks is extremely difficult in modern markets because publicly-available information about any particular stock is immediately factored into its share price. To out-perform the market, an investor must therefore be sufficiently skilled to consistently make the best security selection decisions, something which even the majority of professional fund managers fail to achieve.

The benefits of diversification

Cilbenrick's portfolios are allocated to equities, bonds, property, commodities and cash. Within each of these sectors, portfolios are diversified further into the following sectors, to gain exposure to the largest number of less-correlated assets.

Equities:

UK Large Cap All Companies
UK Large Cap Equity Income
UK Mid Cap
UK Small Cap
European Large Cap
European Small Cap
North American Large Cap
North American Small Cap
Japanese
Emerging Markets

Bonds:

UK Government Gilts
UK Index-Linked Gilts
UK Corporate Bonds
Overseas Bonds

Alternatives:

Commercial Property
Commodities

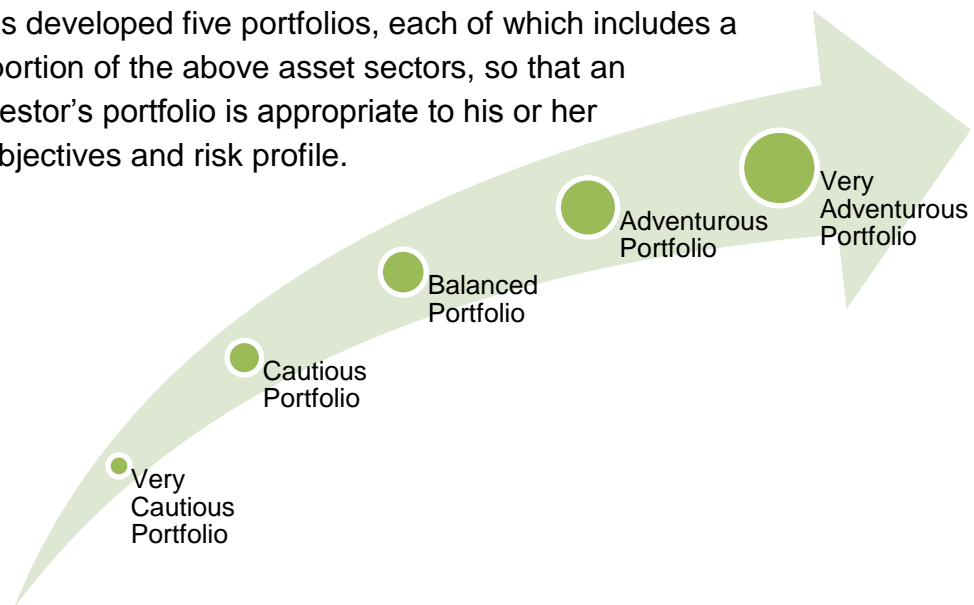
Cash

Diversified portfolios behave very differently to the individual assets of which they are comprised, in much the same way that a cake tastes different from flour, egg, butter and sugar. A cautious investor should not necessarily therefore exclude riskier assets such as equities altogether, particularly as excessive reliance on safe assets may actually increase risk e.g. UK commercial property, a traditionally non-volatile asset class, lost over 25% of values during 2008.

Achieving the appropriate mix of assets

For any given degree of risk, there is a portfolio that will deliver the most return. This portfolio is said to occupy the *efficient frontier*. Unfortunately, the asset mixes that achieve the greatest returns for a given degree of risk only become known in retrospect, as they will depend on economic circumstances. Our aim as asset managers is therefore to identify an asset mix that will come close to the efficient frontier under the broadest range of circumstances.

Cilbenrick has developed five portfolios, each of which includes a different proportion of the above asset sectors, so that an individual investor's portfolio is appropriate to his or her investment objectives and risk profile.



The power of rebalancing

Immediately after a portfolio has been apportioned to asset sectors, its allocation will invariably alter, as the asset sectors behave differently. If left unchecked, the portfolio could acquire a very different composition over time, becoming overweight in assets that have performed best.

Periodically reverting a portfolio to its model allocation not only ensures that its allocation remains appropriate to the risk profile of the investor, but also boosts overall returns by transferring capital from assets that have performed better to those that have not. Rebalancing therefore instils a *contrarian* approach, whereby assets are sold when their prices are high and bought when they are cheap.

Buying low and selling high

Imagine an erratic shop owner who, during some weeks, marks up the price of his goods, and during others, marks the price of the same goods down. The astute customer would stock up when prices are low and avoid mimicking the moods of the shop owner by buying the goods simply because the price is rising.

The financial markets are about as rational as the shop owner in this example. Yet so often, investors apply a '*greater fool*' approach, whereby they actively chase the markets, adding capital to assets with high or rising prices, in the hope that there will be a *greater fool* who will pay a still higher price for the asset, after they have purchased.

Anthony Bolton, the UK's most successful investment fund manager of the last half-century has said of the credit crunch "It is often when things look worst that the best opportunities emerge. I've always been a contrarian investor - running against the pack. It's at times like this that we all have to be contrarians".

The selection of securities

We have so far referred to the content of portfolios only by asset classes (*i.e.* equities, bonds, property, commodities and cash) and by sectors within the asset classes (*e.g.* UK Large Cap equities, European Small Cap equities, UK Government Gilts, etc.). Below the sector level, the constituent parts of a portfolio are in fact individual securities, such as BP and Tesco shares within the UK Equity Large Cap Sector, or 10-year 4.5% gilts within the Government Gilt sector, or actual office buildings and retail premises within the Commercial Property sector.

Outperforming the market as a whole through the selection of individual securities is, as previously mentioned, something that only a select few investment fund managers are able to achieve. Cilbenrick appoint fund managers who have achieved high ratings from independent analysts, Citywire and Morningstar. The ratings are based on how well funds have performed compared to others in their sector. They also consider how much risk the fund managers have taken to produce their returns. A manager who takes lots of risk to produce good returns would be in greater danger of failing to deliver those results in the future. Conversely, a manager who is able to deliver good results without taking too much risk, is considered more reliable for the future. Where we think that no fund manager in any sector is offering sufficient outperformance to warrant their charges, we will propose a low-cost index tracking fund.

Understanding risk tolerance

Decision-making involves choosing between alternative courses of action. Financial risk tolerance is best defined as the extent to which an investor chooses to risk experiencing a lower return or loss in the pursuit of a higher return.

It is essential that an investor's portfolio is allocated to assets in a proportion that is appropriate to their risk tolerance. To help them and us understand their risk tolerance, Cilbenrick's clients undertake a psychometric risk profiling exercise, which is used to help select the portfolio which is to be adopted. The risk profiling system has been developed by FinaMetrica, and it takes the form of a question-and-answer discussion about the investor's attitudes, values, preferences and experiences in matters involving financial risk.

Conclusions

There are two kinds of investors; those who don't know where the markets are headed, and those who don't know that they don't know. Most investment advisers and fund managers know that they don't know, but know that their livelihoods depend on appearing to know.

Effective and successful portfolio construction has been shown to require the following:

- Inclusion of a range of asset classes, according to risk tolerance and objectives
- Diversification across sectors within the asset classes
- Periodic rebalancing to maintain the prescribed asset allocation
- Patience and courage to avoid chasing markets
- Successful selection of individual securities

We understand that investment gains and losses equate, in reality, to our clients' standards of living; the stability of their retirements; and their ability to provide for their families as they would hope to do so. Our investment philosophy, and the methods that we apply in constructing portfolios for our clients, have therefore been given very careful consideration and, to paraphrase Adam Smith, it is through our constant and uninterrupted efforts that we hope to progress towards improvement, for the benefit of our clients' opulence.