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Building a portfolio (4)

The Risk Buckets

In part 3 of "building a portfolio" we considered how to split your funds, and we did this by splitting your fund selection into 3 simple parts or risk buckets. Here we define each risk bucket.

lower risk

This should be the stable core, and we would expect returns at a margin over those available on deposit returns, but not a huge margin. For example, the extraordinarily high returns from corporate bond investments in 2009 were exceptional and will not repeat any time soon. However, there are still clear opportunities across the range of types of investment which fit in this category. Remember the expectation is lower reward as well as lower risk.

medium risk

Here is the inflation-beating potential. We tend to emphasise high yielding equity income funds, because history makes it absolutely clear that this strategy is how you achieve long term outperformance - and all the more attractive right now, with interest rates close to zero.

In the long run we should expect returns at a margin over corporate bond funds and inflation, with total returns (that is growth and dividends) in high single figures.

higher risk

Here is the potential for double digit gains, but with somewhat greater volatility being the price.

There is no purely scientific way to select the funds which populate the risk buckets. In a nutshell three issues are taken into account:

1. Recent past performance; the objective analysis detailed in section 5 sector by sector
2. Value, or lack of it, inherent in certain sectors, and the macro risks; subjective analysis
3. Softer issues around certain funds and fund management groups; even more subjective

In Part 5 we look in more detail at the risks and rewards within each risk bucket, and the types of fund they contain.