EQUITY INVESTMENT

APRIL 2025

Equities form the basis of virtually all long-term investment portfolios, as this is the asset class which most analysts believe provides the **best potential for long term performance**, together with a **hedge against inflation**.

However, as with all assets, a higher potential return also involves being exposed to a **higher risk**. Investors with a short investment timescale, or a low risk tolerance, must be careful not to allocate too much to this asset class.

Here we give an overview of some of the main equity investment strategies available, and how you can gain exposure to this valuable asset class.

Please refer to our note on Risk and Asset Allocation for a discussion on how to determine the level of risk you should take, and consequently the proportion of equity investment which might be suitable for you.

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SUMMARY

Equities (shares) provide **ownership of companies** together with the right to "share" in distributions of profits via **dividends**. Although the holders of company equity effectively own that company, their **rights to repayment of capital on liquidation ranks well down the list** of creditors and behind bond holders. There are different types of equities that hold different rights to dividend payments, voting rights and rights on liquidation.

The shares of large companies are traded on **stock exchanges** such as the London Stock Exchange or Wall Street and the shares of smaller companies may be traded on smaller exchanges such as the Alternative Investment Market (AIM) or held privately by family members and only sold under private arrangements. There are also specialist exchanges such as NASDAQ on which the equities of many technology companies are bought and sold.

Equities are grouped together to form **indices** making it possible to judge how a number of shares have performed collectively. Some well known indices include the FTSE 100, which includes the largest 100 companies in the UK; the Dow Jones Industrial Average, which contains 30 large American companies; and the Nikkei-Dow, which includes 225 stocks quoted on the Tokyo Stock Exchange.

The **price of individual equities can be very volatile**, sometimes moving up and down by considerable amounts in response to changes in supply and demand caused by many factors. These include some that are specific to the company concerned (e.g. an unexpected negative trading statement or profit warning), some that are specific to the particular sector in which that company sits (e.g. a poor outlook for banks as bad debt levels rise in the economy), and some that are specific to equities generally as an asset class (e.g. an unexpected increase in interest rates or possible outbreak of war).

As **price is determined by supply and demand** it can be difficult to judge whether individual equities are fairly priced or under/over valued. Many **valuation methods** are used in an attempt to identify the relative attractiveness of equity prices including:

- **Price earnings (P/E) ratios**: share price divided by earnings per share. Broadly speaking the higher the P/E ratio the more expensive the share price. Companies that are expected to grow their earnings faster will have higher P/E ratios than those in mature industries.

- **Dividend discount**: this method looks at the anticipated future dividends from a company and then discounts these back at a suitable rate to determine a fair current share price.

SUMMARY

Over a long period of time the total return on equities should theoretically be higher than other asset classes. This is because the real capital value of equities should broadly rise in line with the real increase in Gross Domestic Product (GDP), whilst the capital value of fixed interest bonds (effectively just loans) will stay constant as will the value of cash deposits. The total return on equities generally as an asset class over the long term is therefore made up of GDP Growth + Dividend Yield + Inflation.

However, most investors do not invest for an unspecified ‘long-term’, and investors therefore need to be comfortable that there is a **significant risk that equities might not give a good return over the actual time period of investment**, or that they may need to extend their anticipated time period of investment in order to see a profit. The level of risk taken will vary depending upon the investment strategy used, as detailed here.

INVESTMENT STRATEGIES

There are many different investment strategies that investors employ to target a given level of return. In constructing a portfolio of equities, investors should aim for a suitable balance between different styles of investment, to diversify their exposure to any one area.

Investors will also generally seek to diversify their holdings between individual equities, in order to reduce their exposure to the failure of any one company. There are numerous ways in which investors can decide to construct their portfolios, and some of the main considerations are outlined below. There is no ‘right’ model portfolio, as nobody can predict market movements, and the most appropriate portfolio for each individual investor will depend upon his individual requirements.

GEOGRAPHICAL INVESTMENT

Traditionally, equity portfolios have been constructed on a geographical basis. For example, a typical UK investor may have around half their portfolio in the UK, with the balance invested in the US, Europe and to a lesser degree in the Far East and Emerging Markets. Although the major world markets tend to move increasingly in line with each other, there are still significant differences between the markets that makes diversification overseas potentially beneficial.

INVESTMENT STRATEGIES

GEOGRAPHICAL INVESTMENT

In addition, some markets generally have a higher level of dividend yield than others – for example, the UK market has historically had a much higher dividend yield than the US. Investors should also be aware that increasingly, companies that are listed on one market may have significant operations overseas, and so investors may also have indirect overseas exposure. Some companies "hedge" this currency exposure, making it broadly neutral for the UK based investor, however many companies do not.

In constructing a geographic portfolio, account must be taken of the currency risks involved in investing abroad, the respective potential growth in each country (for example, some commentators may believe that the Far East offers greater potential for growth over the next few years than Europe), and the respective levels of financial security (e.g. market regulation, transparency, political security) in each country.

THEMED INVESTMENT

An alternative way to look at the investment world is through themed funds. The idea is to identify themes, e.g. industries, which are likely to do well in the world economy of the future. For example, expanding areas may include: technology, media, healthcare, pharmaceuticals, telecommunications, commodities and financial services.

Themed funds can be used as part of a geographically balanced portfolio, or indeed some investors may believe that themed investment is more important than regional weightings, and not seek to constrain their portfolio geographically.

STYLE OF STOCKS

Various styles of investment can also be used and given different weightings in a portfolio according to the investor's preferences. For example, stocks (and fund management styles) are often split into 'Value' and 'Growth' styles.

Value stocks would include those where future capital growth was not expected to be particularly high, but where a good dividend income stream could be generated – typically large 'blue-chip' companies. Growth stocks would include those where capital growth was expected to be high, however, little dividend income could be expected in the short term. Investors may weight towards one or other style at different points in the market cycle – generally a balance between the two styles is advisable.

Investment managers may also have a mainly 'top-down' or 'bottom-up' investment styles: 'top-down' where the manager looks first at macro factors (e.g. economic growth projections), and then selects shares in the areas they identify will benefit from the expected macro direction; 'bottom-up' where the manager selects companies they identify on individual merit, regardless of type or sector. In practice, the two styles are usually used together to some degree, e.g. bottom-up with a top-down overlay. However, some fund managers do lean more in one direction than the other.

In addition, investors may decide to weight towards different sizes of company, from large cap (capitalisation), mid cap, to small cap companies. Small company shares may offer a higher growth potential, but are likely to be more volatile and perhaps less liquid. Again, a balance between the different market caps is generally advisable.

INVESTMENT STRATEGIES

ACTIVE AND PASSIVE MANAGEMENT

Active funds will generally use one or more of the investment strategies detailed above to try to achieve a return higher than a stated benchmark (e.g. the FTSE All-Share index), or the average of their particular sector of funds. However, mathematically, the average fund can only ever achieve the average return, and so there will be some funds that at some point underperform the benchmark/sector. An investor will naturally invest in those funds that he believes will consistently outperform, however, there is no guarantee that this will be the case.

Some investors, therefore, invest in passively managed ('index-tracking') funds, which use various techniques (e.g. buying all or some of the shares in an index in the same proportions as the index, and the use of mathematical models) to attempt to replicate the performance of an index. The success of this method is measured by the "tracking error", i.e. the percentage that the fund over or under performs the index. Even if the fund manages to exactly replicate the performance of the index, after charges have been deducted, the fund will generally underperform the index. These funds, therefore, limit both the potential upside and downside, relative to an index. However, the investor knows that the chances of significantly under performing the index should be greatly reduced, and tracking funds are often significantly cheaper than an actively managed fund in the same area.

There are some markets where commentators generally believe it is harder to outperform the index. These are markets that exhibit a higher level of 'efficiency', i.e. the information that drives the share prices is more widely available to all investors, and so is priced into the market more rapidly. This is generally thought to be the case with the US, the UK and, to a lesser degree, some European markets. Other markets, such as the Far East and Emerging Markets, are generally thought to be less efficient and active managers may find it easier to outperform the index in these areas. Investors may, therefore, wish to consider using index tracking funds for a proportion of their equity exposure in some areas, both to reduce the overall annual management charges, and also to further diversify the investment styles within their portfolio.

INVESTMENT STRATEGIES

ABSOLUTE AND RELATIVE RETURNS

Some investors have become interested in measuring their return in absolute terms rather than relative to an index. It is very difficult for a fund manager to make money by holding equities in a market where equities in general are falling, regardless of the qualities of the individual stock. A successful manager in this situation may achieve a fall in value of 20% compared to a market fall of 30%, but the value of the investment will have fallen nonetheless. Traditionally, an investor who required security of capital would have invested in cash, gilts and perhaps some bonds, and received a potentially lower return than equity investment as a result. However, products are available which make use of financial derivatives and purport to offer an alternative.

These absolute return strategies seek to make positive returns regardless of market conditions – i.e. they seek to enhance the risk/return equation beyond that which is traditionally available, for example, by promising the risk level of cash, with returns higher than those of bonds. Whilst seeming to promise the holy grail of investing (higher return for lower risk), there are also disadvantages inherent in these strategies and, as with all investments, investors should ensure that they are fully informed before committing themselves. For further details, please see our Research Note on Hedge Funds.

METHODS OF INVESTING

Investors have the choice of three main types of service when making equity investments:

- **Discretionary management**: the investor effectively gives the manager an investment mandate (required level of risk, investment income etc), and gives the manager authority to make investment decisions for them. The service can be fee and/or commission based – and may only be cost-effective for those with larger portfolios. Please see our separate Research Note on the merits of individual and collective equity investments for further details.

- **Advisory management**: the investor will pay an adviser for advice on the most suitable investments for them. The service can be fee and/or commission based. However, the final investment decision rests with the investor.

- **Execution only**: this is a dealing only service, available through stockbrokers, banks, building societies, and increasingly commonly through online-only providers. The service is generally commission based, although minimum and maximum fees will usually apply.

In addition, investors have the choice of investing in equities individually, or through collective investment funds (e.g. unit trusts). Collective funds may be more suitable for those with smaller portfolios, those requiring access to more specialised areas (e.g. emerging markets) or for those who do not have the time or the expertise to manage their own individual portfolio. Please see our separate Research Note on the subject for further details.

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Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.