Building a better portfolio

3 HABITS OF HIGHLY EFFECTIVE INVESTORS

iShares
by BlackRock

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Investors often start by filling their portfolios with funds run by the top-rated fund managers. But the reality is that the 'best' funds do not lead to the 'best' portfolios.

Here are three habits shared by some of our most successful investors.

1
UNDERSTAND THEIR PORTFOLIO RISK

2
KNOW WHAT IS DRIVING PERFORMANCE IN THEIR PORTFOLIO

3
USE A RANGE OF INVESTMENT TOOLS

1 UNDERSTAND THEIR PORTFOLIO RISK

We've found that successful investors begin by carefully considering the **risk** they are prepared to take, as this can be easily controlled by carefully choosing the assets they invest in, i.e. their **asset allocation**. For example, an investor who wants less risk might make sure that a large part of their portfolio is invested in lower-risk bonds.

The aim is to design a portfolio that balances the return an investor wants with the risk they can afford to take.

Risk — While the investment approach described herein seeks to control risk, risk cannot be eliminated.

EXPLAINER:
Risk refers to the chance that an investment's actual return may differ from the expected return. There are several ways to measure risk, many of which focus on the probability of losing some, or all, of the original investment.

Asset allocation refers to the overall mixture of stocks, bonds and other asset classes like commodities in your portfolio, and how much of your total portfolio is invested in each one.

Keep your balance

Instead of buying heavily into one kind of investment that could drop in value and bring your whole portfolio down, the right balance of investments keeps successful investors **diversified** across the market.

Risk — Diversification and asset allocation may not fully protect you from market risk.

Investors who have given thought to the asset classes they want to invest in, and their **broad market exposure**, have a much better understanding of their portfolio and the risks they are taking.

This is key to achieving desired investment goals.

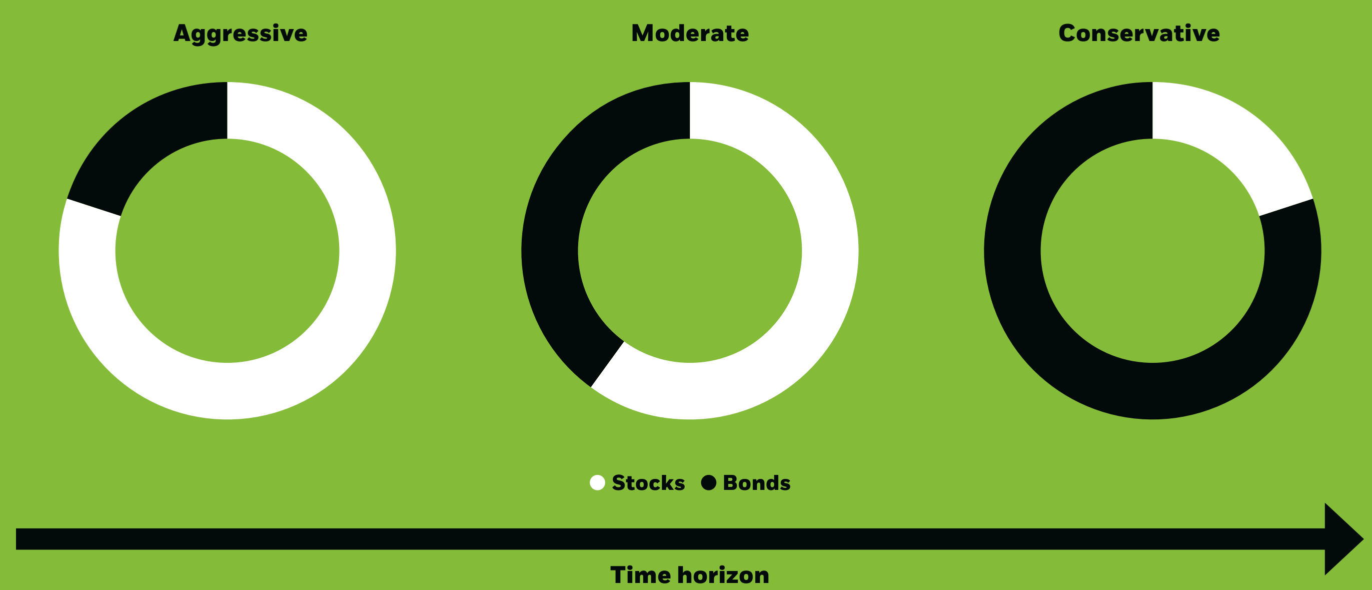
EXPLAINER:
Broad market exposure refers to the wider markets in which a portfolio is invested. For example, the success of an investment in an Indian pharmaceutical stock will be affected by events at the company but also, events in the pharmaceutical industry and events in India.

What guides your investment choices?

Your investment choices can be guided by both your time horizon and your risk tolerance.

Your time horizon is the length of time over which you have to achieve your financial and investment goals.

Your time horizon will influence how much risk you are prepared to take. Someone aged 25 and just starting to invest could potentially afford to make more aggressive investments, as there's more time to recover from steep price falls. Someone close to retirement might want to invest more conservatively.



This is for illustrative purposes. This is not a recommendation or advice.

The graphic above shows the way assets could be allocated depending on the investor time horizon.

The 'aggressive' portfolio has a large proportion invested in stocks and a much smaller investment in bonds.

The 'moderate' portfolio still allocates more to stocks than bonds, whereas the 'conservative' portfolio is mainly invested in bonds.

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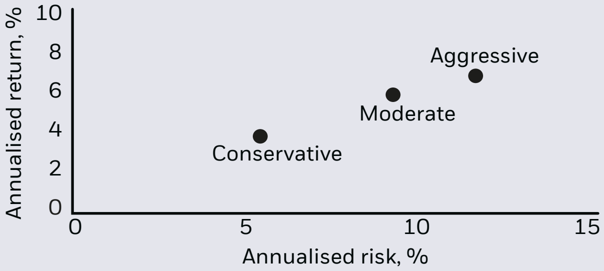
Your tolerance to risk: This refers to how much risk you would be willing to take. Could you handle losing part of your investment for the chance of a higher return?

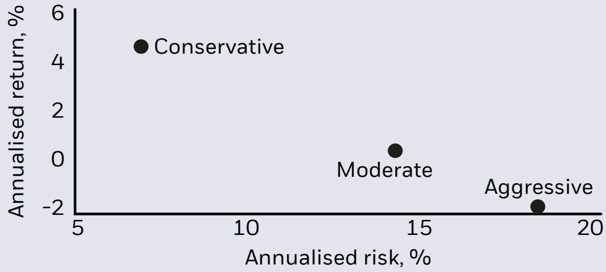
Unlike your time horizon, your attitude to risk is personal. Some investors love the thrill of chasing high-risk returns, others may be emotional at the thought of potentially losing some of their investment and prefer to take a more cautious approach.

Take a look at these graphs that compare annualised risk and annualised return over different time frames.

Returns over 10 years (from 30 Apr 2011 – 30 Apr 2021)



Returns over 12 months (from 30 Apr 2020 – 30 Apr 2021)



The figures are for illustrative purposes only and results cannot be guaranteed. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: BlackRock, from 30 April 2011 – 30 April 2021. Currency = USD. Data frequency = Monthly. Bonds represented by Bloomberg Barclays Global Aggregate Bond Index; Equity represented by MSCI World Index. Cautious = 20% Equity; 80% Bonds. Moderate = 60% Equity; 40% Bonds. Aggressive = 80% Equity; 20% Bonds. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged, and one cannot invest directly in an index.

If we look at the returns over 10 years for these portfolios, it may look as if an aggressive asset allocation is always desirable. However, if we look at returns over a shorter time period, the performance of these portfolios has been reversed.

These graphs show why when making investment decisions, it is crucial to consider your time horizon, as well as your own level of tolerance to the amount of money that you might lose on any given day, month or year. Whilst over the longer run, higher risk investments may earn a higher return, there may be shorter term bouts of volatility and more severe losses which investors need to be able to have the financial ability as well as emotional willingness to tolerate.

What does this mean for investors?

Choosing the investments best suited to you doesn't have to be complicated. The focus should be on designing a diversified mix of asset classes and exposures and considering the risk of your investment portfolio as a whole. This will help to ensure that your investments remain towards your defined goal.

Indexing for simplicity

Indexing can give investors exposure to a broad basket of stocks or bonds. For example, an investment in an index fund or ETF tracking the MSCI World Index gives exposure to over **1,500 companies from 23 countries and 10+ sectors**.[1]

Investing through indexing therefore provides a simple and transparent way to express your asset allocation and market views, whilst ensuring that you remain diversified and in control of your risks.

Risk — Diversification and asset allocation may not fully protect you from market risk.

1 BlackRock, MSCI, as at June 2021.

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KNOW WHAT'S DRIVING PERFORMANCE IN THEIR PORTFOLIO

The returns from a single stock will often be driven by company-specific events, but also by factors such as the country where the company operates, the associated sector and fundamental characteristics (such as if the stock is under-priced).

The same applies to both funds and the overall portfolio.

What does this mean for investors?

When thinking about what drives portfolio outcomes, the major driver is broad market exposures — even the strongest of companies or funds may fail to perform well if the local economy is suppressed. For investors, this means that greater focus should be on getting your market view right, as opposed to selecting the best or most well-known stocks or managers. This is ultimately what will define your success.

Indexing for cost control

Knowing that indexing vehicles — **index mutual funds** and **Exchange Traded Funds (ETFs)** — are an efficient way to capture broad market exposures, successful investors are opting to index a greater portion of their assets. This helps reduce the need to continually monitor **alpha-seeking manager** performance. This allows investors to invest in selective alpha fund managers, who they really believe can outperform the market, which will often come at a fee premium.

EXPLAINER:
An **index mutual fund** is a type of **fund** that's built to match or to track a financial market **index**. So, for example, a FTSE 100 index fund will track the movements of the FTSE 100.

ETFs, much like index funds, are funds that aim to track the performance of a specific index, such as the FTSE 100. The difference is that ETFs are 'marketable securities', which means they have a price and can be bought and sold on financial exchanges, just like a share.

Alpha-seeking managers take contrary bets to their benchmark, with the objective of achieving a higher return and outperforming the broad market.

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3 USE A RANGE OF INVESTMENT TOOLS

With the growing number of investment tools available to investors, it is becoming obvious that there is not just one way to invest.

Previously, investors might have focused on the regional or country views that they wanted to express in their portfolio — for example, taking a view on favourable returns in US stocks over European stocks. There are now many different ways for investors to think about building their portfolio.

Use more tools

With a huge surge in funds focused on Environmental, Social and Governance (ESG) solutions, investors now have the ability to express views around sustainability, based on the premise that companies with greater social responsibility could be more likely to outperform in the future.

Similarly, we have seen a huge growth in thematic investing, where fund managers select stocks based on megatrends that are transforming the way that we live. These are long-term investments, designed to capture companies poised for long-term growth.

All of these new investment ideas are helping to increase diversification for investors and provide an exciting opportunity to branch out into different investment areas. Successful investors have reviewed their past investment choices and adapted their processes to take advantage of additional ways to achieve returns.

What does this mean for investors?

With the growth of data and technology helping to evolve the index strategies available, the high fees charged by alpha-seeking managers are becoming less justifiable, especially for **long-only strategies**.

Risk — The return of your investment may increase or decrease as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation.

EXPLAINER:
Long-only strategies — This means the manager **buys** positions in different stocks believing they will deliver positive returns. (As opposed to long-short trading strategies, where managers can buy and sell positions in different stocks, so they can earn additional returns by selling stocks they believe will underperform.)

Indexing for results

In many instances, we find that the additional return that an alpha-seeking manager may be able to generate above that of its benchmark can be quickly eaten away by their management fees. For this reason, many successful investors have been able to achieve similar outcomes much more cost effectively by indexing.

As investing evolves, driven by **technology, tools and transparency**, the role of indexing is becoming more and more important. It's time to start building better portfolios.

Want to know more? iShares.com

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Risk warnings

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