Investment Philosophy and Process – General Outline

Over the years we have sought to develop a consistent investment approach. This briefing note discusses development of this philosophy and how we now apply it to client money.

Financial Planning

Investment of capital should not take place in isolation. To achieve the best results investment should be made against a background of properly considered goals and time frames. It should be made in a way that takes account of your tolerance and attitude to risk. This is financial planning.

Financial Independence

We all dream at one time or another of winning the lottery. Apart from giving us the wherewithal to buy what we want, what is really most people's reason for wanting to win the lottery? We believe it is financial independence.

We define financial independence as having sufficient capital or income to give you the choice as to what you want to do. That is the income from our investments will support us indefinitely. These numbers will be different for each of us. As the odds of winning the lottery are so poor the only realistic way for the vast majority of us to attain financial independence is through our own efforts. For example, by saving from income or by investing intelligently, or by building and selling a business or perhaps from an inheritance.

We believe that the two biggest risks to achieving financial independence are one, the failure to properly plan and two, poor investment decisions. This note looks at investment decisions.

Investment philosophy

Over time we have developed what we feel is a consistent risk assessed value process to managing client money. There are eight key factors that govern this process.

1) Market Efficiency

We believe that markets are efficient. This is not to say that markets are perfect pricing mechanisms in all cases. Mis-prices clearly do occur but it is virtually impossible for any active manager to consistently find and exploit these mis-prices and hence 'outperform' the market.

2) Value will always reveal itself

Various studies have shown that a value approach consistently outperforms a growth approach. By 'value' we mean stocks with a low book to market ratio. In other words the value of the business assessed by conventional accounting methods divided by the market capitalisation should be a low ratio. This book to market ratio is assessed relative to all stocks in the market. No stock picking is involved.

3) Cost control is essential

The costs of running a portfolio will have a dramatic effect on performance. Consider an average mixed fund that may achieve a 6.5% annual return. The annual management charge may be 1.5% and the total expense ratio 2.0%. From this we deduct our servicing rebate of 0.5% leaving a net charge of 1.5%. 1.5% from 6.5% leaves 5% return to you (4.5% after you pay us). A reduction in return of 23%. Our process reduces this cost.

4) Asset Allocation is Key

Various studies, but especially that by Fama and French[1], have shown that about 90% of the return of a portfolio is achieved by asset allocation not stock selection.

Asset allocation is the balance between the four main investment asset classes of cash, bonds, property and shares. Asset allocation in respect of shares alone is the balance between different market segments and 'value' and 'growth' stocks. Managing the relative proportions of these within a portfolio in respect of your attitude to risk and time is the most certain way of achieving the desired outcome.

5) Diversification is Essential

Holding just one stock or even just one fund exposes you to market and specific risk. But just buying another fund or share would not diversify your portfolio if they have the same characteristics. For example, holding Shell and BP would not be diversifying. With funds it is necessary to ensure that the underlying holdings are not correlated otherwise one would just have more funds, not less risk.

6) Individual risk tolerance must be accurately judged

One man's low risk investment is another man's high-risk investment. None of us have exactly the same view of risk.
It is also true that risk and reward are closely related, especially in investments. We therefore take pains to assess your individual attitude to risk. This again cannot be done in isolation. For example, you may consider yourself to be a low risk investor and feel happy only when invested in assets like cash and government bonds that give security of capital (if we ignore inflation). However, you may also have the goal to retire early. If so this will almost certainly require a higher investment return than cash and Gilts could ever realistically be expected to achieve. Therefore you are running the risk of not achieving your goal.

So which risk is most important to you? The investment risk (and potential reward) inherent in investments or the risk of not achieving your goals?

7) Discipline

The biggest enemy to successful capital acquisition is most often ourselves. We are emotional beings and we can often be influenced by external forces and events. We must beware that decisions we make are not driven by these events and our emotional reaction to them.

8) Capitalism (or Free Market Economics) Works

Companies borrow money from investors, that is shareholders. They also borrow money from banks and others to gear up or leverage shareholders funds and this can accelerate the returns. The purpose of the company is to make a return on this capital that is greater than its cost. Companies pay dividends to shareholders and the increase over time in these payments drives the price of the shares upwards. Of course not all companies prosper, some die, but overall businesses do thrive and grow. Capitalism is not a zero sum game. When these successful businesses prosper so do their shareholders.

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History

Over the last 10 years, that is since we set up Williams Farrall Woodward, we have applied a system based on that described above to try and defend the value of your investments and achieve reasonable returns. We have devoted a considerable effort to this and although we believe we have achieved reasonable results we always feel that we could do better. By 'do better' we do not mean 'make you more money'. No one in the world can do this for you and we have never promised it in the past, and will not in the future. Only you can make you money. No, what we mean by 'do better' is to achieve market rates of return consistent with the level of risk you find tolerable and at lower cost. To do this we have to develop a process for investing that is based on sound financial research and efficient systems.

Process

After considerable research we have decided to further outsource our portfolio process whilst still retaining control of asset allocation.

In particular we wanted, as far as is possible and practical to take active management (and its costs and failures) out of the picture but we did not want to use slavish index tracking (because of their poor value and inefficient formula driven stock trading).

We also wanted to retain some form of value approach to stock purchase.

There are three legs to this process:

1. Outsource Manager

This document is not the place to set out all the work and analysis we have carried out in researching the various managers to whom we could outsource investment management. This work has led us to select five main investment managers as follows.

1. Dimensional Fund Advisors

   Dimensional offer a select range of funds an investment process based on which use modern Portfolio Theory. These are value driven passive funds priced in accordance with the institutional model. These funds form the core of our portfolios.

2. Norwich Union

a) To fill the Global Equity Large Cap ex UK gap in Dimensional's fund range we have selected the Norwich Union International Index Tracking Fund.
b) We believe that exposure to commercial property is useful in most portfolios. As an asset class commercial property does not appear to correlate with equities or bonds and it offers a useful yield. Our analysis has shown that an exposure of about 10% in our range of medium risk portfolios can provide useful reduction in volatility without affecting returns.

3) Legal & General

   To fill the UK All Share gap in Dimensional's funds range we have selected the Legal & General UK all share index fund.

4) Bedlam Plc

   To fill the Japanese Smaller Companies gap in Dimensional's fund range we have selected Bedlam Plc Japan Fund. (There is more comment on Bedlam below)

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5) Principal Investment Management

We have foreseen that for certain clients a complete bespoke private client service may be the most suitable solution. If this is the case we have selected Principal Investment Management.

Bedlam Plc would appear to be the complete antithesis of our preferred passive process driven approach to investment management. However we believe that they are sufficiently special to differentiate themselves from the broad run of "active" managers.

They have a rigorous process and a simple methodology to stock picking. They view all stocks as if they were about to buy the whole company. A cash trade buyer philosophy. They also do not benchmark themselves but simply seek to make 1.5 to 3 times the return on the risk free asset, cash. They are also driven by value preservation. Lastly they have a novel fee structure that is designed to benefit them only when you have also made money.

2. Administration

The second leg in this process is the administration and monitoring of the portfolios. Again, we have adopted an outsourcing approach but one that is integrated with our internal computerised client management system. We have developed a stratified approach to this process as different administrative platforms suit different clients. So for clients with invested assets in the range of £40,000 – £70,000 we use one or another of the fund supermarket services like Cofunds or Selestia. For clients with assets in the range of £50,000 – £60,000 upwards we use Transact. All of these services talk electronically to our back office system allowing us to properly analyse and integrate your portfolio with any other investments you may hold.

3. Standard Portfolios

Having selected an outsourced manager we have developed a standard portfolio model based on a new risk assessment process. The asset approximate allocation models of these are set out below[3].

<table>
<tr><th>CLIENT RISK PROFILE</th><th>EQUITIES %</th><th>BONDS %</th><th>PROPERTY %</th><th>CASH %</th><th>TOTAL %</th></tr>
<tr><td>Low Risk</td><td>0</td><td>60</td><td></td><td>40</td><td>100</td></tr>
<tr><td>Very cautious</td><td>20</td><td>80</td><td>0</td><td rowspan="5">See below</td><td>100</td></tr>
<tr><td>Cautious</td><td>39</td><td>56</td><td>5</td><td>100</td></tr>
<tr><td>Moderate</td><td>54</td><td>36</td><td>10</td><td>100</td></tr>
<tr><td>Aggressive</td><td>72</td><td>18</td><td>10</td><td>100</td></tr>
<tr><td>Very aggressive</td><td>100</td><td>0</td><td>0</td><td>100</td></tr>
</table>

Please note that the above are provisional asset allocations as the 12th December 2005.

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Cash is only specifically held as an asset class in the Low Risk Strategy. For the other five strategies cash is considered to be held within the underlying funds and as an operating balance of about 2% in the clients general investment account. Furthermore as we usually recommend that clients hold adequate emergency funds in cash we feel that additional cash holdings in the strategies are superfluous.

Terms, Conditions and Cost

We have completely revised our terms of business and engagement to reflect this better engineered approach. Our terms are a service fee of maximum 0.5% p.a. of assets held through our agency or modelled on our system, excluding cash held as savings and your main and second homes, plus fees as incurred on our standard time charge rates. We will discount the percentage service fee for larger holdings.

You should note that by using a process as described above we can reduce average annual management charges by between 100 to 200 basis points. In other words our service fees are, at very least, self financing. We think that this is good value.

Conclusion

We have thought and worked hard to develop this process and we are confident that it will deliver better risk rated returns for our clients. By its very nature this briefing note only covers the outline of our investment process. If you require a more in depth analysis please ask.

Notes.

1. Fama & French – Developed the Three Factor theory. Google them for more information.
2. Modern Portfolio Theory. Go to moneychimp.com for the best description we know of.
3. Our standard strategies vary slightly from these ideals. We will discuss the strategies with you.

The foregoing is Williams Farrall Woodward's current understanding of investment matters and the regulations associated with them. These are subject to change and whilst every effort is made to keep the information accurate it cannot be guaranteed. Clients must not act on the information given without obtaining professional advice. E & O excepted.

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