# MAC Financial Advice LLP

# *The MAC Freedom Portfolios*

*An Introduction…*

The new 'MAC Freedom Portfolios' enable us to use our experience with investment trusts as well as unit trusts – all in the same portfolios.

We tested the proposed new portfolios, so we could see how we could put them together and also explain them succinctly. We also tested them to see how they might work in practice – and the results were very encouraging – see below.

We have been working with the platform and investment provider, Avalon, for some time and they have delivered very well. With this in mind, we have taken the decision for Avalon to hold the new 'MAC Freedom Portfolio's upon their platform.

*For further information, please contact our financial consultant:*

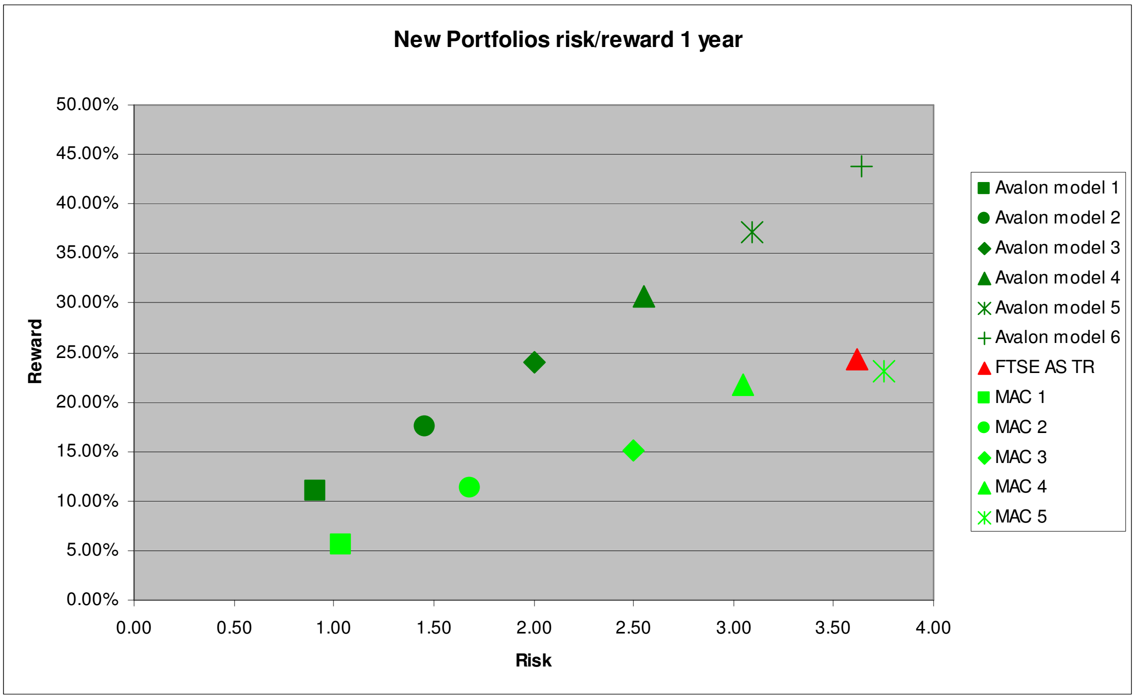
***Chris George***

*T: +44(0)2072349113*
*E: chris.george@macfinancial.co.uk*

*MAC Financial Advice LLP*
*1 The Grain Store*
*70 Weston Street*
*London*
*SE1 3QH*

*T: +44(0)2072340789*
*W: www.macfinancial.co.uk*
*E: info@macfinancial.co.uk*
*Twitter: @Macfinancial*

***Visit our investment website at:***
*http://www.macfinancial.co.uk/investments*

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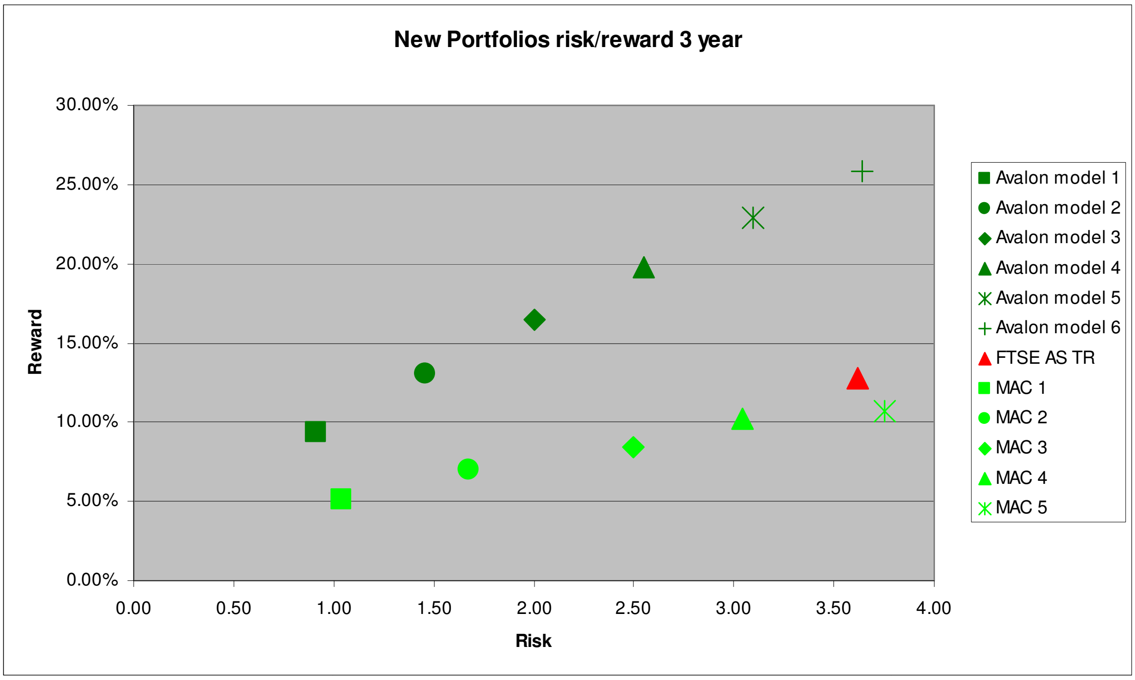


## So What Are They?

Essentially, they are based on a favourite theme of ours – gilts and warrants

Back in the days when interest rates were higher you could get 10% a year from gilts – this would be enough to double your money in about 7 years. If you invested half your money into such a gilt you could invest the other half in anything spicier (e.g. warrants) and you knew that you had to get back at least your total amount invested after 7 years – and any return from the spicier investment was pure profit, e.g.:-

| Invest | Now | 7 years time @ bad return | *7 years time @ high return* |
|---|---|---|---|
| Gilt | £ 50,000 | £100,000 | £100,000 |
| Spicier investment* | £ 50,000 | £nil | £150,000 |
| | —— | —— | —— |
| Total | £100,000 | £100,000 | £250,000 |

In other words, if your spicier* investments do well, you benefit, but if they do badly you still get your total investment money back. We have always built our model portfolios broadly along these lines but with the availability of using investment trusts we can better achieve this now.

The "spotty graphs" shown on the previous page show, as ever, the return achieved up the side axis, versus the risk experienced along the bottom axis, so the higher the dot and the less it strays across to the right the better. The light green dots are our current model portfolios and the red triangle is the FTSE All Share index (with income re-invested; i.e. Total Return); the dark green dots are the new Freedom portfolios on the same basis.

Rather than building six separate portfolios all we have done is to build two portfolios – a safe one and a scary one.

Then we have simply combined them in the proportions of:-

| Model | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Safer portfolio | 100% | 80% | 60% | 40% | 20% | 0% |
| Scarier portfolio | 0% | 20% | 40% | 60% | 80% | 100% |

Owing to minor HMRC reporting issues we then set them as six individual portfolios and rounded the percentages in the funds, so as to improve the administrative efficiency – but it's the same effect – a percentage in the safe portion with the balance aggressively invested.

The dark green dots indicate how each of these mixes would have performed historically up to mid-year – please note that this is purely historical performance and may not fully account for all costs, although that should make only modest difference.

For purely practical reasons these portfolios are only available for lump sum investments, not regular savings; also, as there are several investment trust holdings some models require a minimum investment of around £50,000.

## What is in the portfolios?

Think of them as two separate portfolios – looking at the safer one first, it contains several zeros (zero dividend preference shares), a couple of infrastructure-oriented investments, aiming at steady income returns, a multi-asset managed fund and a UK growth investment fund for a small element .

The aggressive portfolio comprises almost purely equities. One of the funds has some non-investment earnings, which helps broaden the return base a little, while several of the funds are investment trusts. Four UK funds plus four global funds gives a majority in UK shares, with a significant proportion overseas.

Investment trusts have a particular advantage in rising markets in that they can borrow to leverage up the investment return – generally up to 15% leverage is fairly normal. In both rising and falling markets they also benefit from the fact that they can hold their "investment pot" intact regardless of the fund's cashflows. This can be particularly irksome for managers of open ended funds, as they are often forced to sell their most liquid holdings in a downturn and can find it very difficult to buy back in at a good price as they have to wait for the cash flow to come back in.

By contrast, one of the investment trust managers, in particular, was running a UK fund which had a lot of smaller company shares in it back in 2006-09 and was able to buy a short ETF with barely 5% of the fund assets and this enabled him to have around one third of the fund in cash at the bottom of the market, so he had plenty of money to buy lots of cheap shares when he wanted to, as well as being able to hold on to the shares that he wanted to keep during the crash. This does not necessarily mean that the fund's price will not fall more than for an open-ended fund but it does offer a very real opportunity to significantly outperform across the cycle.

This means that the aggressive portfolio element may well be more volatile than an equivalent portfolio of purely open-ended funds but, at the same time, the safer portfolio element should be rather more stable so, by combining the two appropriately, you should be able to ride out the bumps better while still achieving healthy longer term returns.

One of the advantages of this type of approach is that I have found that you can get a generally higher return per unit risk. If you look at the "spotty graphs" again you can see that the dark green spots suggest that our new Freedom portfolios would have achieved the same return as the FTSE All Share index but at not much more than half the volatility risk, whereas if using our old model portfolios you would have needed to take around the same level of risk as for the index.

This is interesting and surely worth exploring.

Our old model portfolios have delivered well but this approach, which I first started using more than twenty years ago, looks attractive.

## A few caveats

There may be a few dealing difficulties with some of the investment trusts – especially with some of the zeros – as the market can be quite thin. This can apply when looking to exit as well as when buying, so you need to separate investment risk and liquidity risk in your own mind.

Some of the investments, the zeros, will have a limited life and will need replacing once redeemed.

The elements in the aggressive portfolio can and will move down more sharply than some others when there are falls – their subsequent recovery will almost certainly be sharper, though, and they may well outperform most funds through the full cycle.

They all stick to our basic principle of giving you a set of general funds rather than highly focussed funds, such as a European fund or a Japanese fund, which might have required you to make switches from time to time. Barring replacing the zeros as they redeem, you may well find that you do not need to make any switches for really quite a while.

This all possibly means that these new Freedom portfolios might need viewing from a slightly different perspective, in that volatility is often the only really quoted measure of risk, whereas one could argue that longer term permanent full or partial loss is more important overall.

Next are extracts from a piece by Greg Davies, head of behavioral investment philosophy at Barclays:

*"In the quest for investment returns, classical finance theory makes little room for sentimentality.*

*Estimates suggest that investors lose 2%-5% of potential returns each year simply because being human makes the principles of classical finance hard to follow.*

*By ignoring the important role of emotions, traditional portfolio solutions end up making investors uncomfortable along the journey, and that frequently leads to poor decision making and lower performance.*

*For example: we pay too much attention to the short term; we overreact to market movements; we buy when markets are doing well, and sell when markets are low; and we retain large portions of our wealth in cash, unused and unproductive.*

*If you are anxious that markets will fall, selling out provides the relief of knowing you will not lose any more money.*

*But once you have left a turbulent market for emotional reasons, it is almost impossible to quickly get back in again, no matter how good the logical case for it.*

*You lock in the losses and miss the eventual rally. This is short-term emotional comfort purchased at enormous financial cost."*

He does go on to say that if you need it you should buy emotional security but in my experience too many people accidentally worry too much about the wrong things and then totally overlook what they should have been more concerned about, with the inevitable outcome.

For example, let us assume that someone had £100,000 in his pension ten years ago

| | |
|---|---|
| *If invested in the average Gilt fund this would now be worth* | *£155,290* |
| *If " " " UK Smaller Companies "* | *£286,950* |

When he checked five years ago he would have got a rate of 7.2% pension income, which was OK (= £11,180 from gilt fund now)

On taking his pension he now finds that he can only get 5.3%, as the GAD rates have fallen (GAD = Gov't Actuaries Dept, drives income rates)

This means that he could now only get income of:-

£ 8,230 from the Gilt fund (which has a volatility (ie risk factor) of 1.66)
Or £15,208 from the UK Smaller Companies fund ( " " ) of 3.87)

As he was looking forward to a retirement income of £11,180, which of the funds represented the highest risk and which the lowest risk?

According to the textbooks his lower risk option would have been to invest in the Gilt fund, whereas the bigger risk was the change in GAD rate, so, in effect, he could never have achieved the pension income he wanted by using the, lower risk, gilt fund, whereas had he used the, apparently higher risk, UK smaller companies fund he would have achieved a big enough fund to comfortably meet his income expectations - we leave you to draw your own conclusions.

## Back to the point

The point behind these two items is that so very often investors become embroiled in the nitty gritty detail but miss some key points with their money. Basically, if you want to invest your money over a reasonably long period of time you really do need to think about how best to do just that, and not get too bogged down with short term issues.

With our new Freedom model portfolio we would encourage you to think about your true investment horizon and pitch accordingly. If you do proceed with a fair percentage or all in the more aggressive elements please be aware of the above points and accept that you need to hold most investment through the rough as well as the smooth to get better results than if you keep switching in and out. We quite appreciate that good timing can help but, as you can see from Greg Davies' comments, few achieve this and, instead, suffer poor returns.

*For more information on these portfolios, please contact us at:*

*MAC Financial Advice LLP : +(0)207 234 0789 : info@macfinancial.co.uk*