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Asset classes explained

When you choose investments, you can't know how well they will perform. The return you get will depend on a variety of factors, such as the impact of charges, the particular shares or other investments selected, how stock markets in general move, and the asset allocation you choose.

Asset allocation and asset classes

Asset allocation means the proportion of your portfolio that you put into each asset class. At its simplest, an asset class can be defined as a broad type of investment.

Traditionally, there have been four asset classes: cash, fixed-interest securities (also called bonds), property and shares. However, there is a constant search for new asset classes, such as commodities and hedge funds.

A better definition of an asset class is: a broad type of investment whose risk and return tend to be unconnected with the risk and return from other asset classes. Mixing different asset classes helps you manage the amount of risk you take with your portfolio, a process called diversification.

Managing risk

One of the most important aspects of risk is the amount by which your returns are likely to swing up and down, called capital risk. Different asset classes have different levels of risk. For example, cash (investing in things like savings accounts) has low capital risk.

Ranked in order of increasing capital risk, the traditional asset classes generally come out like this: cash (lowest risk), fixed-interest, property and shares (highest risk).

If you want a low-risk portfolio, you would aim to hold a high proportion of your investments as cash and fixed-interest. A higher risk portfolio will have a relatively high proportion in shares.

How much to have in each asset class

In an ideal world, you'd get high returns from your savings and investments with no risk! Sadly, in the real world, there is a trade-off – to get higher returns, you have to accept higher risk.

The younger you are, the more risk you can afford to take, because you have many years of working life ahead with opportunities to increase your saving and investing. When you are older, you have less opportunity to make good any losses on your investments, so you should normally tend towards a lower risk portfolio.

One rule of thumb is to take away your age now from 100 and this tells you what proportion of your portfolio to have in shares. For example, if you are 30 now, the rule says put 100-30=70% of your portfolio in shares and the rest in lower risk assets; if you are 60, put 100-60 = 40% of your portfolio in shares.

The rule of thumb is only a very rough and ready guide. If you are not confident choosing your asset allocation, get help from an independent financial adviser.

How to invest in an asset class

Whenever you choose a particular savings account, say, or specific shares you are building up your asset allocation. For example, if you have all your money in bank and building society accounts, you automatically have a 100% cash allocation. So, one way to invest in asset classes is to be mindful about the type and amount of particular savings and investments you choose.

Another way to invest a proportion of your money in a particular asset class is to use tracker funds. These are investment funds that are designed to move up and down in line with a particular stock-market or other index. For example, some tracker funds invest in shares and aim to track the FTSE-100 share index; others invest in fixed interest and aim to track, say, the iBoxx £ Non-Gilts Index; others track a property index; and so on.

Automatic asset allocation

With some investments, you can leave the asset allocation decision to experts. For example, some investment funds, typically called 'mixed investment' aim to hold a specified proportion of the fund in shares. For example, a 'mixed investment 0-35% shares' fund would be a relatively cautious portfolio holding no more than 35% of its investments as shares, while a 'mixed investment 40-85% shares' fund would be much more aggressive with up to 85% of the portfolio in shares.

Another example of automatic asset allocation is where you invest in a pension. If you do not say how you want your contributions invested, they will usually automatically go into a default fund. Generally this will be some sort of 'lifestyle' fund, where the proportion invested in shares will be high if you are young and will automatically shift to the safer asset classes of cash and fixed-interest as your retirement date approaches.