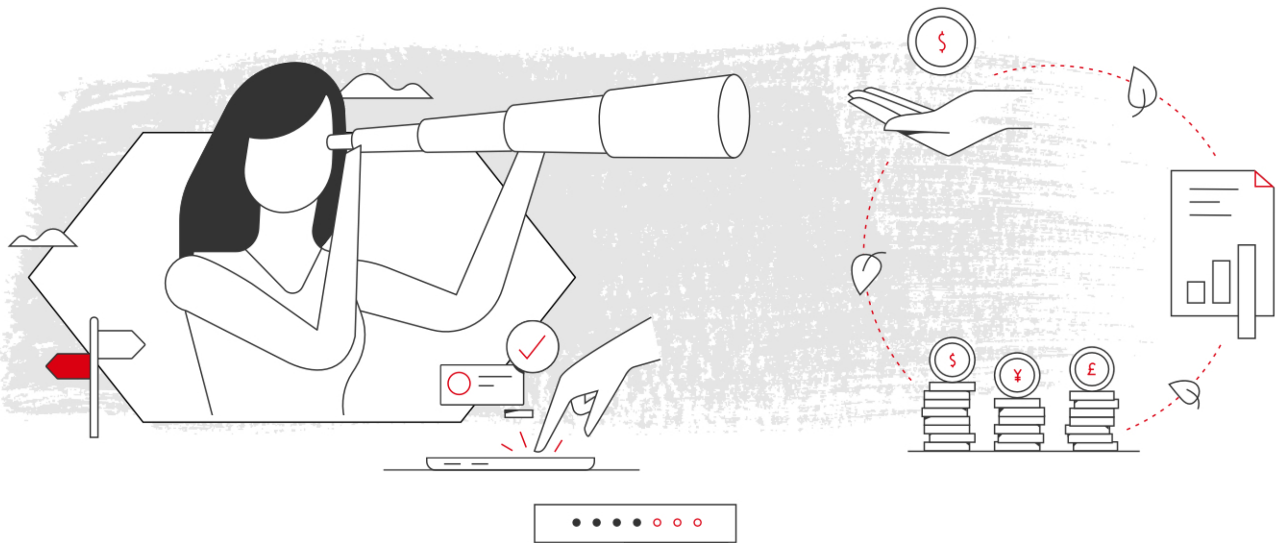

Day 4: How to build your portfolio

Time to read: 6 minutes

Today we're going to show you some basic concepts or approaches to building your portfolio. You've already learned that disciplined investors spread their risk of losing money by not putting all their eggs in one basket (diversification) and you've learned about 3 types of assets that can help with diversification.

Building a portfolio, then, is the art and science of mixing different types of assets to optimise your risk and return to meet your investing objectives. If it sounds complicated – well, honestly, it can be. But we'll show you a few practical approaches to get you started.

Let's do some theory (just a little – we promise)

The first thing to know is that diversification won't eliminate all risk – there's no such thing as a perfect portfolio. The reason for this is that when you're investing you're exposed to two different types of risk.

Market risk
This includes: interest rates, inflation, exchange rates and even things like political instability or a global pandemic. These things affect all companies and you can't diversify against market risk. (It is possible

to use hedging strategies to manage this type of risk, but that's pretty complicated, so we'll save that for a more advanced course).

Business risk and financial risk
These are risks you can diversify against. Financial risk is a company's ability to manage its debt and business risk refers to whether the company will be able to generate enough revenues from operating to cover all of its expenses.

Correlation & diversification
Let's say you love China tech stocks and build a portfolio of 10 of the hottest tech companies in China. Then the government announces a new policy affecting the tech sector that causes all tech stocks to sink in value. Even though you have spread your risk by owning more than one stock, they're all the same type of stock, so they tend to behave the same way. We say they are "positively correlated".

A better way to diversify is to find assets that are negatively correlated – meaning that if one goes down, the others remain stable or potentially go up. This is what creates less risk in your portfolio. (There's lots of complicated maths involved as to how optimise for risk and return. If you want to learn more, google: "Harry Markowitz". He's an economist who won the Nobel Prize for his work on modern portfolio theory.)

And while it's important to diversify within an asset class (e.g. equities), it's also important to diversify across asset classes, by adding, for example bonds to your portfolio. That's because in general, when equities go down, bonds go up and vice versa. But like many things in investing, it's never quite that straightforward. There are many instances where both asset classes went down at the same time, but it's an acceptable rule of thumb.

If it still sounds difficult, luckily, William F Sharpe (another Nobel laureate) worked out that while choosing the right investments is important, what's more important is your "asset allocation"[1]. That's your "asset mix": basically how your portfolio is divided between the different asset classes. There are a few common ways to figure out a ratio that's right for you.

3 ways to allocate assets

Lifecycle Investing
A simple, popular method for selecting your asset mix is to subtract your age from 100. So if you're 25 years old your asset allocation would be: 100-25 = 75, which would give you a portfolio that is 75% equities and 25% bonds.

Our table shows you a few more simple examples. A 40-year-old would have a portfolio that is 40% fixed income assets and 60% equities, but a 21-year-old's would be 21% fixed income assets and 79% equities. Meanwhile someone who is near retirement at age 65 would have a portfolio that's 65% fixed income assets and only 35% equities.

** This has been modified and simplified for illustration purposes*

What's good about this method is that it's easy to understand and it naturally adjusts your risk profile as you get older. A younger investor with a 30 to 40-year investment horizon can probably afford to take more risk and may opt for a 90/10 split between equities and bonds (it's a personal choice).

As you approach retirement though, you'll want to protect your investments by moving them to lower risk assets (e.g. fixed income) that you'll need to fund your lifestyle when you stop working.

One consideration is that as people are living longer, it may be more practical to use 110 or even 120 as the starting figure to give your portfolio a chance for the extra boost that stocks can provide.

This is a great place to start but remember: it's just a rule of thumb. Your age, your investment goals and your risk tolerance will also help determine your asset mix.

Risk-based asset allocations
Another way to allocate assets is to build a portfolio based on you overall risk tolerance. To start investing at HSBC and other licensed firms it's mandatory to answer some questions that help you understand how you respond to risk – for example a big downward swing in the market. We call this the Risk Profile Questionnaire and we'll talk more about it on Day 6.

Based on your answers, you could be classified as either: Cautious, Balanced, Adventurous or Speculative. At HSBC, our asset managers provide model portfolios based on your tolerance for risk. They might help guide you to create an investment portfolio similar to the table below, but would only do so after having a detailed conversation with you to understand your objectives, lifestyle and a host of other factors to help create the right asset allocation for you.

Example of a portfolio allocation based on risk profile:

	Cautious	Balanced	Adventurous	Speculative

** This table is just to give you an example. We're not suggesting or recommending you buy anything based on this.*

Using funds
Instead of building a personalised portfolio of specific equities and bonds, many people find it easier to buy funds. We spoke briefly about index funds and unit trusts (or mutual funds) in the previous lesson, but let's take a closer look at unit trusts.

These are funds that are put together by professional managers. They are ready-made portfolios of assets and they can be bases around specific industries (medical, tech, automotive) or market regions (like Hong Kong, developing economies or southeast Asia) or based on a different category.

The benefit of a unit trust is that the fund manager is actively managing the portfolio. If it isn't doing as well as expected, the fund manager can edit the portfolio, removing underperforming assets and

adding new ones.

Another benefit to unit trusts is that they are fairly "liquid": it's easy for you to buy in or sell off at any point. (Although many investors look at funds as a medium- to long-term investment.

While unit trusts are a good option for many investors and offer a wide range of investment choice, there are a number of important factors you need to consider when buying into them.

- As they are run by professionals, there are fees associated with buying and holding a unit trust. It's important that you consider how the amount of fees you pay can affect your long term returns.
- Some, but not all funds, have high minimum investment amounts which may not meet your budget. But don't worry, it's very easy to find funds that are cost effective. You will also need to pay attention to any restrictions on withdrawing money from the funds, but in general, most retail funds make it easy to move money in and out.
- Lastly, even professional fund managers find it really hard to "beat the market". In fact, in March 2019, the S&P Dow Jones (one of the U.S. stock markets) reported that over a 10-year period, 85% of actively managed funds underperformed the market.

So why do people do it? Remember, buying a unit trust means someone else does all the hard work of diversification and asset selection. This can take a lot of the emotional stress and worry out of wondering whether or not you have made the right choices.

You'll still need to understand a little about the fund's strategies and the assets that go into it, and you should always read the relevant fund documentation, but investing in funds is a good, simple way for a lot of people to get started investing.

What's next?

Today you learned about what kinds of risks can and can't be managed through diversification and the importance of asset mix over picking individual stocks. You also learned 3 ways to approach asset allocation to help you get started building your first portfolio.

Next lesson, we'll tell you about compounding returns – one of the most powerful forces in investing and the key to building long-term wealth.

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1. Sharpe, William F. 1970. "Portfolio Theory and Capital Markets"

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