A guide to

passive investment

architas

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Welcome to our guide to passive investing. At its heart, passive investing means trying to track a certain market, such as UK or European stock markets, and achieve returns as close to that market's returns as possible.

This style of investing has grown rapidly over the past ten years. In part due to it being a relatively straightforward way to invest in markets, such as stocks and shares, but also because it is seen as a cost effective way to invest when many people are put off by seemingly high charges.

In step with the growth of passive investing is the growth and development of the Architas Multi-Asset passive fund range over the past 10 years.

We hope this guide informs you about the basics of investing in funds, the benefits of asset allocation and how passive investing itself works. The guide ends by providing some detail about the Architas Multi-Asset Passive fund range: passive by nature, diversified by design.

Alex Burn
Investment Manager,
Architas Multi-Asset
Passive Fund range

WHAT IS **A FUND?**

THE BASICS :

WORKINGS:

FUNDS ARE TYPICALLY USED BY PEOPLE LOOKING TO INVEST IN VARIOUS ASSETS

with the aim of meeting their financial goals, but who don't have the time to research and manage the investment themselves.

POPULAR TYPES OF FUNDS & MANAGEMENT:

SINGLE ASSET CLASS / GEOGRAPHIC FOCUS

Funds that have a single asset class focus (usually stocks, bonds or property) can also have a geographic or regional universe. A few popular examples are European equity funds, emerging market bond funds and UK property funds.

MULTI-ASSET FUNDS

These are funds that invest in several different types of asset classes, which may include bonds, equities, property, commodities and more. They may invest directly in these asset classes or they may gain exposure by buying other funds in the 'fund of funds' structure.

ACTIVE FUNDS (ACTIVELY MANAGED)

In this type of funds, the fund manager(s), assisted by a research team, makes ongoing decisions about which investments to hold, buy or sell in the fund with the aim of outperforming the market.

PASSIVE FUNDS (PASSIVELY MANAGED)

The fund will invest in the stocks of a particular index (such as the FTSE 100) or commodity with the aim of tracking the performance of that market but without seeking to outperform it. Some passive funds can also invest in – and aim to track the performance of – multiple indexes or commodities, which provides potential diversification benefits.

A FUND IS A TYPE OF INVESTMENT CREATED BY AN INVESTMENT COMPANY THAT INVESTS MONEY ON BEHALF OF THEIR CLIENTS.

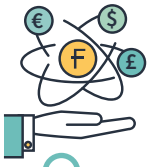
In this type of structure investors in a fund pool their money with other investors. The pooled money is then invested in-line with the objective of the fund.

IT WILL HAVE AN OBJECTIVE TO ACHIEVE SUCH AS DELIVERING A REGULAR INCOME OR TRYING TO GROW YOUR MONEY.

This objective usually outlines the mix of investments that are used to achieve it.

THE JOB OF BUILDING THE ASSETS PORTFOLIO IS DONE BY A FUND MANAGER.

A fund manager will use their specialist knowledge to choose the investments, and each investor owns a portion of the total fund.



THE FUND MANAGER CAN INVEST IN DIFFERENT TYPES OF ASSET SUCH AS CASH, BONDS, STOCKS AND PROPERTY.

These are normally described as asset classes. Exactly what the fund manager buys depends on the investment objective of the fund.

THEMES/SECTORS

Theme or sector funds are on the rise as part of a well-diversified portfolio. Examples of theme based funds are those with investments in socially responsible investing or the digital economy. Sector investing offers targeted coverage to the stocks of companies in specific segments of the economy such as technology or healthcare focused funds.

FUND OF FUNDS

A type of fund that invest in a selection of other investment funds (referred to as the fund's underlying funds) instead of investing directly in stocks or commodities. 'Funds of funds' are also often known 'multi-manager funds'

MIXING IT ALL UP

While there is no right answer, a popular choice for investors is to spread risk by building a portfolio with a mix of the above. This could include an allocation of passive funds or multi-asset funds covering the broader market, then adding a few industry or geographically specific funds, depending on the individual investor's goals.

INVESTING **WITH PASSIVE FUNDS**

Are you looking to invest? With so many choices, it can be tough to pick the solution that best suits your needs. Keeping up to date with the changes in financial markets can be difficult even for investment professionals, and for an individual investor it can seem a little overwhelming.

Depending on your circumstances, a simple solution could be to invest in passive funds. Passive funds are referred to by a variety of names, including index trackers, index funds or even just tracker; the term 'passive' reflects the fact that your investment is designed to mirror the returns of its selected market or benchmark.

What's a benchmark?

The majority of funds have benchmarks against which their performance is measured. The key point is that passive funds are designed to match the rise of the relevant benchmark, whereas active funds look to outperform their chosen benchmark.

One well-known index that is often used as a benchmark is the FTSE 100. The FTSE 100 is composed of the 100 most valuable companies listed on the London Stock Exchange. When used as a benchmark, the FTSE 100 would act as a point of reference against which the performance of the fund can be compared – your fund should mirror the returns of the companies in the index. This allows a clear and simple measurement of the performance. There is one obvious question to be asked here - if active funds are trying to beat their benchmark, why would you invest in a fund that only looks to match its benchmark? This is when you need to start getting into the detail, and where a bit of research and knowledge comes in handy.

Picking an active fund manager that regularly beats an index fund is very difficult; if it wasn't, everyone would be beating the market! Active funds rely on the conviction and research of the manager and their team – sometimes they pick well, other times their luck is out. An active fund based on sound principles can be very successful one year, but not necessarily do well the next. Changes in the market, company management or the political landscape are just some of the things that can see the best-laid plans fail to bear fruit. It all starts to get a bit tricky.

When comparing returns, you also need to take management fees into consideration; these are generally lower for passive funds than for equivalent active funds, and these cost savings are passed onto investors.

What are the benefits of passive investing?

Compared to active funds, passive funds offer investors a lower cost route into the market. The fund manager's investment process is very transparent and rule based.

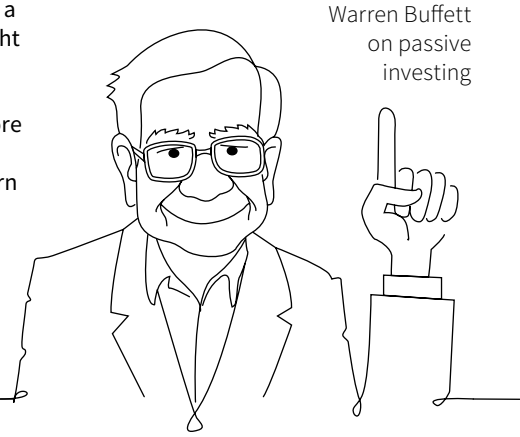
This means that fees are generally lower and investors are able to access market growth more cost effectively. While active managers are able to add performance over and above an index they can also underperform, and many investors therefore prefer the more consistent approach of a passive fund.

Are passives risk free?

No. With all their benefits comes the trade-off of receiving index-like return; markets can go down as well as up, so if you are invested in a tracker fund and the market your fund is replicating drops, then your investment could lose value. By investing in a fund that mirrors market returns you will be benefiting from the good and the bad, which could mean positive or negative returns; the upside as well as the downside.

In fact, there are certain areas of the market where we believe passively managed investments are not likely to be as effective as actively managed ones. Liquidity of assets is also important, liquidity refers to a market's ability to allow assets to be bought and sold easily and quickly, the reduced liquidity of opaque markets such as high yield bonds or alternatives can make it more difficult for a passively managed portfolio to achieve its objective of providing a return similar to the index.

> "I think it's the thing that makes the most sense practically all of the time.
>
> Warren Buffett on passive investing



Who invests in passive funds?

Passive funds are bought by many types of investor, including high net worth individuals such as Warren Buffett, charities, large pension funds, and even individual investors who are able to put a bit aside into an ISA. The amounts invested range from a few thousand to billions of pounds.

It's important to remember that choosing between active or passive investing is not the only decision investors need to make. An investor must be aware that asset allocation will dictate a large portion of the investors risk and return profile.

Asset allocation is how much, as a proportion of your total investment, is allocated to various asset classes such as equity, property, bonds or cash. Diversifying your investment is an established way to guard against market volatility - in essence, don't put all of your eggs in one basket.

Passive investing could be for you

Passive management can play a role in your portfolio. It's really about evaluating what you want from an investment and prioritising what is most important to you. The bottom line is that having a bias for or against any style of investing could mean that you miss out on the potential benefits of another solution.

Actively managed funds offer the chance to beat the market, but you need to pick the right manager and remember that they carry higher risk and higher fees. Passive funds might offer less potential upside, but they are simple and affordable.

If you are after a low cost investment strategy that is simple to understand, easy to implement, should match the performance of the fund's chosen benchmark, and may give you the chance to beat the average actively managed fund's returns over the long term, then passive investing could well be for you.

ASSET ALLOCATION
CAN SMOOTH THE BUMPY ROAD

We look back on 2018, a year that has been an uncharacteristically volatile time for some markets compared to the past decade.

This is a result of multiple factors, one being because central banks are starting to return to more normal conditions by withdrawing their super-charged stimulus. Other influences adding uncertainty into markets have been the trade war escalation, rising interest rates in the US, UK political uncertainty and a number of emerging market currencies collapsing sparking concern.

We believe risks in the market are fairly evenly balanced with strong global growth, falling unemployment and solid company earnings having a positive effect. However we are conscious that investment returns may continue to vary from one asset class to the next and the difference between asset classes could continue to widen.

This potential for more dispersed performance emphasises one of the key benefits of diversifying across a range of markets and asset classes. Understandably for any investor, volatility creates nervousness. In particular passive investors may feel worried as the purpose of passive funds is to track the returns of the markets, both on the upside and the down.

However, one of the reasons that passive investing may have become increasingly popular in recent years could be the growing recognition that asset allocation is more important than individual security selection. Asset allocation is the most crucial part of the portfolio construction process.

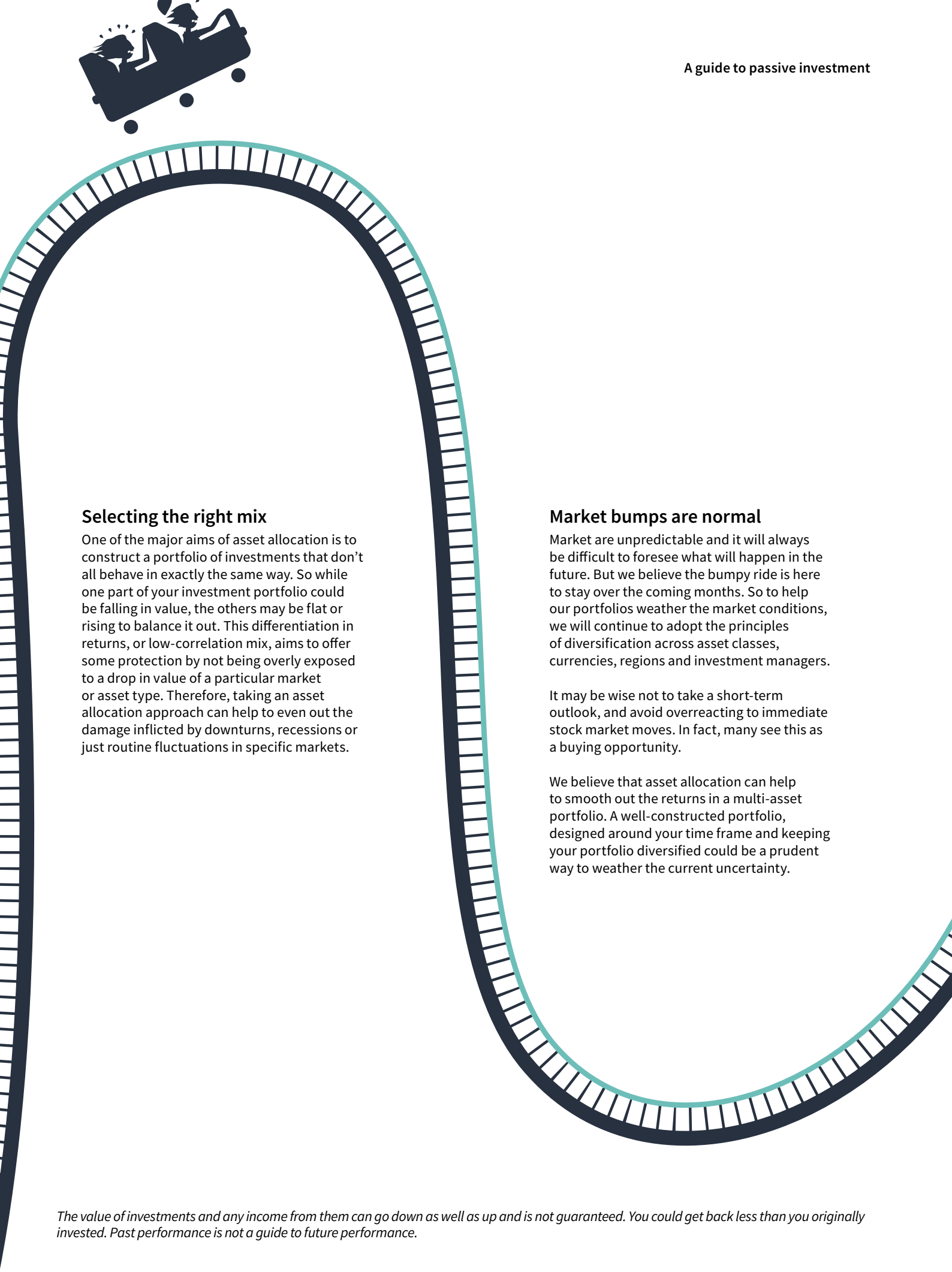
Asset allocation is king

Asset allocation refers to the decision of how much capital to invest and where, for example in stocks vs. bonds, in US vs. European stocks (which are often referred to as equities), how much to keep in cash and how much to invest and everything in between.

Having the right balance—the optimal asset allocation—is what keeps you diversified in the market.

Many studies have evidenced asset allocation, is by far the biggest driver of returns. One such study* attributed that over 90% of long-term returns came from decisions about a portfolio's asset allocation rather than picking the right time to invest or selecting which stocks to buy. This research shows that investors who maintain a suitable asset allocation are more likely to succeed over the long-term.

*study, Gary P. Brinson, Brian D. Singer, and Gilbert L Beebower



Selecting the right mix

One of the major aims of asset allocation is to construct a portfolio of investments that don't all behave in exactly the same way. So while one part of your investment portfolio could be falling in value, the others may be flat or rising to balance it out. This differentiation in returns, or low-correlation mix, aims to offer some protection by not being overly exposed to a drop in value of a particular market or asset type. Therefore, taking an asset allocation approach can help to even out the damage inflicted by downturns, recessions or just routine fluctuations in specific markets.

Market bumps are normal

Market are unpredictable and it will always be difficult to foresee what will happen in the future. But we believe the bumpy ride is here to stay over the coming months. So to help our portfolios weather the market conditions, we will continue to adopt the principles of diversification across asset classes, currencies, regions and investment managers.

It may be wise not to take a short-term outlook, and avoid overreacting to immediate stock market moves. In fact, many see this as a buying opportunity.

We believe that asset allocation can help to smooth out the returns in a multi-asset portfolio. A well-constructed portfolio, designed around your time frame and keeping your portfolio diversified could be a prudent way to weather the current uncertainty.

The value of investments and any income from them can go down as well as up and is not guaranteed. You could get back less than you originally invested. Past performance is not a guide to future performance.

THE OPENING UP **OF THE CHINESE MARKET**

In a landmark move during the summer of 2018, a major index provider, MSCI, included more than 230 Chinese stocks, known as A-shares, in its emerging market indexes.

A-shares are the stocks of Chinese companies listed in mainland China and quoted in the main domestic currency, the renminbi. This means if you invest in an emerging market index fund that uses the MSCI index as a benchmark, which many do, you will now be investing in previously difficult to access Chinese companies.

The types of exposures which are available through the domestic market are far more centred on the 'new economy' such as IT, consumer and healthcare with access to unique sectors such as baijiu (or white liquor), home appliances and traditional Chinese medicine. Offshore Chinese shares, known as H-shares, are typically more 'old economy', characterised by energy, materials and industrial stocks.

What is the impact?

When new stocks are added to an index the key thing is that passive funds must then buy them in order to match that index correctly. However, the initial changes following their introduction are relatively small. To avoid unsettling markets, MSCI is proceeding gradually with only a maximum of 5% of the total value of companies added to the index with this limit slowly increasing over the next three to five years.

This introduction of a limited number of Chinese A-shares to the MSCI benchmarks is the beginning of a long process to add all A-shares to international benchmarks. The hope is that the addition of these companies to global benchmarks will be accompanied by an improving, all be it from a low base, attitude by regulators to open and improve protection for foreign investors in domestic stocks. Of more significance is the improving goodwill from investors towards the Chinese market and an increase by more globally focussed portfolio managers to include some of the larger Chinese shares in their portfolios

Risks and opportunities

Despite the recognition by MSCI, some investors are concerned about the potential risks of poor corporate governance and the possibility of trading suspensions in these A-shares. However many see this as an opportunity to increase the variety of companies they can invest in from the world's second largest economy; improving the diversification benefits to global investors. Additionally, these onshore shares are typically private companies rather than state-owned enterprises and so have the potential for higher profit and efficiency levels than government-owned companies.

How we access the market

The bulk of Architas' passive fund range's exposure to China is through the funds' exposure to emerging market index funds rather than country-specific funds.

Outlook for China

We are encouraged by the way China is attempting to slow down the level of debt in the country, globalise its currency and financial markets and increase the quality of the companies. However, despite the assumed longer-term benefits of an improved economy in the short term, this change creates uncertainty and volatility.

Our current outlook for China is therefore mixed, in the near future there's the potential for increased market volatility and negative markets, although over the longer term we are broadly positive. Our position at this current moment is therefore selective and somewhat cautious.

MSCI Emerging Market Index

China H-shares: 31.5%
China A-shares: 0.8%
South Korea: 13.9%
Taiwan 11.7%
India 8.8%
Europe, Middle East, Africa 14.3%
Latin America 11.5%
Others 7.5%

THE ARCHITAS **MULTI-ASSET PASSIVE FUND RANGE**

The Architas Multi-Asset Passive range is a collection of six funds, each of which is a fund of funds.

These investments follow a strategy where each of the Architas funds invests in a portfolio of specialist underlying funds offered by asset managers rather than investing directly in assets such as stocks or bonds. The range offers low-cost access to diversified multi-asset portfolios with distinct risk profiles. We believe that these funds have the potential to help you achieve your financial goals in a cost effective way. Our fund of funds range aims to provide:

Emphasis on suitability

Each fund targets a specific risk profile which acts as a guide to the risk you may be exposed to. The funds are managed to stay within these risk profiles through rigorous, on-going monitoring and rebalancing.

Investor focus

The funds have an easy-to-understand investment strategy that is transparent and process-driven with suitability for investors at the heart of it.

One-stop diversification

The fund of funds structure allows you to make a single investment that provides exposure to a variety of sectors, industries, countries and asset classes across a range of carefully selected funds provided by specialist asset managers.

Dedicated investment team research

There are strict risk controls in place when the team researches and invests in funds. You can feel secure in the knowledge that they have been subjected to a thorough due diligence process.

Best in class approach

Our team select the underlying funds they believe are most appropriate and most cost effective for each portfolio, in line with each fund's objectives, rather than being tied to a group of underlying funds.

Low cost access

As a member of the global AXA Group we are able to offer investments and access to managers at preferable rates. The ongoing charge figure (OCF) you would pay ranging from 0.44% to 0.45% depending on the fund within the range*.

At Architas multi-management is our business with £24.5 billion of assets under management and advice**. We have a commitment to research, with one of the largest multi-manager focussed teams in the industry and the backing of the global AXA Group***. Our aim is to offer investment solutions to help investors achieve their goals. We want to see investing carried out as it should be – straightforward, transparent and with suitability for investors at the heart of it.

*OCF data correct for S share class as at 31 October 2018. **As at 30 September 2018. ***Architas is 100% owned by the AXA Group but we have no legal right of access to the assets of the AXA Group.

IMPORTANT **INFORMATION**

The value of investments and any income from them can go down as well as up and is not guaranteed, and you could get back less than you originally invested. Past performance is not a guide to future performance. These funds may not be appropriate for investors who plan to withdraw their money within five years.

If you need more information on any of our funds, you can ask us for a free copy of the Key Investor Information document (KIID) and the prospectus. You can also view or download all of our funds' KIIDs from our website at **architas.com**, by following the Key Investor Information documents link from the home page and in the information centre.

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The Architas customer support team is on hand to answer your questions.

Call 0800 953 0197

Monday to Friday 9.00am–5.30pm; calls may be recorded. Calls are free from landlines and mobiles within the UK.

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