The model in practice: 3 investment classes explained

ETFs, Funds and Individual shares can each have a role to play in your overall asset mix. Here we outline their different benefits.

ETFs – the market in a share

Exchange Traded Funds (better known by many investors as iShares, the brand owned by Barclays Global Investors ('BGI') have been around in the UK since April 2000, with the launch of the iFTSE100 on the London Stock Exchange. From a slow start, by the end of 2005 (the latest figures available), some £125 billion was held in assets under management. Generally, when you look for your share price information, you'll find them grouped in the extraMARK section, where you'll now find some 45 different ETFs on offer.

Although they have been around for sometime, let's just remind ourselves how ETFs work. They are listed on the stock exchange, providing the flexibility and tradeability of a share, including the fact that the price is continuously quoted, but that one share can provide instant exposure to an entire Index, giving you the diversification benefits of a fund.

ETFs are also a flexible way of achieving cost-effective market exposure. Because the funds are registered in Ireland, there is no stamp duty to be paid on purchases. Management costs are taken from dividends that are accrued by the fund, and any excess income is then distributed to shareholders: unlike unit trusts, there are no initial fees to pay on the original purchase. The price of the fund is always close to the 'Net Asset Value' (NAV) of the underlying investments and will usually have tight spreads, unlike some unit trusts and some investment trusts. Also ETFs will disclose their holdings everyday, whereas traditional funds usually disclose their holdings twice a year.

What can I invest in?

ETFs offer a wide range of opportunities for investment with varying levels of risk: as at mid-December there were 45 different markets/indices to invest in, ranging from corporate bonds to the Taiwanese market.

Starting at the lower end of the risk spectrum there are several corporate bond ETFs, as well as some Gilt-based investments. Moving on to the medium risk level, you can choose from global funds to ones that are more specific to individual regions, such as the US or Asia. There's also the option of investing in individual indices: 'index trackers' are available for the UK's FTSE100 and 250 Indexes, the US S&P 500, or Europe's Eurofirst 100 & 80, spanning the top European companies.

For those wanting a higher level of risk, there are also ETFs which will give you exposure to emerging markets, such as Turkey, Korea, Taiwan and Eastern Europe.

You can use our SharePicker online tool to search for information about individual ETFs – just enter 'ishares' into the 'by company' search box for details of all BGI-issued ETFs.

ETFs don't offer the same wide variety as unit trusts, but for investing in the countries and sectors they do cover, their charging structure and tradeability make up for this. As such, they provide a good, low cost, easily-traded route into the market, with the flexibility to move up the risk ladder as your experience and capital grows.

Finally, if you've an appetite for an even spicier approach, the London Stock Exchange also enables you to invest in commodities, through ETCs (Exchange Traded Commodities). Although like ETFs they are traded in the same way as shares, and are eligible to be held in a PEP or ISA, they do work in a completely different way.

Whereas ETFs actually buy the underlying investments, ETC managers don't buy and store tons of wheat and copper, stack-up barrels of oil, or herd livestock into pens. Rather, they buy options on these commodities. As a result, ETCs are classed as more 'complex' investments by the FSA and you'll need to complete a special 'risk notice' confirming you understand the additional risks of investing in them. (You can print this from the 'managing your account' section of the 'forms' page on our website – www.share.com/forms.)

So take a fresh look at ETFs – you might just find they offer you more than you thought!

Funds: take your pick of the best

Unit Trusts and Open Ended Investment Companies (OEICs) are investments that let you pool your money with lots of other 'retail' investors. This money is invested on your behalf by a wide range of specialist fund managers, investing in, for example, Government gilts and bonds, commercial property and equities.

Investing in funds gives you access to a highly-diversified range of investments at a reasonable cost. You will also have easy access to asset classes and international markets that would otherwise be difficult and expensive to invest in and benefit from the Fund Manager's contacts, knowledge, experience and expertise.

Funds come in many shapes and sizes from 'trackers' to specialist or 'themed' funds.

An index-tracking fund (often referred to as a 'passively managed fund') aims to match or 'track' the performance of a given market index, such as the FTSE All Share or the FTSE 100. They do this using computer programs to work out how much of each individual company they need to buy and sell to mimic the performance of the Index as a whole. But not all 'tracker funds' match the Index they are tracking that well – so be sure to check their record.

An 'actively managed fund' on the other hand employs researchers to study and engage with companies in which they plan to invest, and to keep abreast of the prospects for companies in which they already invest. They'll compare their performance to a 'benchmark' index related to the investment objectives of their fund, with the expectation that the extra work they put into tracking down the 'best' investments will literally pay dividends through higher growth than that of their benchmark.

Choosing your funds

When you pick your funds, be sure to rate them against other funds that fish in the same waters. Don't expect a 'value' fund and a 'growth' fund to have similar track records. Only by comparing funds with their true peers will you make a good choice. Whilst past performance should not be seen as an indication of future performance, past performance does matter when comparing like with like. Chasing winners however, is as dangerous as day-trading. Not surprisingly, all five of the top-performing funds at the end of 1999 were technology sector funds. Sector funds have a place in many a portfolio, but for the majority of investors they belong at its edges, not at its heart.

An individual fund will give you a wider spread of underlying investments: by investing across a number of funds you're better able to smooth out the ups and downs of the market overall. But that won't work if it turns out that your funds hold virtually the same investments. So have a look at each fund report to see their top holdings and make sure you've got a good spread overall.

INVESCO Perpetual Monthly Income Plus Acc (Lower risk)

Investment objective To achieve a high level of income while seeking to maximise total return through investing in high yielding corporate and Government bonds, together with UK equities. The Fund Manager's policy is to ensure that the fund's asset distribution is suitable for most UK investors seeking a high level of income.

Our opinion This fund has a good track record and a structure that helps limit the effect of a fall in the equity market. It is most suitable for the more cautious investor looking to avoid volatility.

30.09.01–30.09.02	30.09.02–30.09.03	30.09.03–30.09.04	30.09.04–30.09.05	30.09.05–30.09.06
-6.0%	31.0%	14.7%	13.6%	8.9%

Performance details are based on a mid price, sterling basis, inclusive of net reinvested income to 31st October 2006.

INVESCO Perpetual UK Growth Fund (Medium risk)

Investment objective To achieve capital growth through investment in shares of companies in the United Kingdom mainly, but not exclusively, in the FTSE 250.

Our opinion This fund is slightly more volatile than our lower risk choice (above). This extra volatility comes from the fact that it only invests in shares, so it doesn't have the bond exposure to help balance any fall in the equities market. By investing in this fund you are effectively investing in the expertise of its manager, Ed Burke, who has a very strong track record. Suitable for those investors looking for growth in the UK market.

30.09.01–30.09.02	30.09.02–30.09.03	30.09.03–30.09.04	30.09.04–30.09.05	30.09.05–30.09.06
-13.7%	35.2%	15.7%	21.0%	16.7%

Performance details are based on a mid price, sterling basis, inclusive of net reinvested income to 31st October 2006.

Jupiter Ecology Fund (Higher risk)

Investment objective To achieve long-term capital appreciation, together with a growing income, consistent with a policy of protecting the environment. Its investment policy is to invest worldwide in companies which demonstrate a positive commitment to the long-term protection of the environment.

Our opinion A fund that invests around the globe and which is ranked number 2 this year (and 17th over the last 3years) in the 'ethical investments' market. It allows you to look outside the UK to the US, Europe and the Pacific region, including Japan. The fund has a good track record in the ethical/green investment sector. However, it does come with risks – in addition to the effects of currency fluctuations, you will need to bear in mind other factors, such as geographical and political risk.

30.09.01–30.09.02	30.09.02–30.09.03	30.09.03–30.09.04	30.09.04–30.09.05	30.09.05–30.09.06
-26.3%	15.2%	1.8%	24.6%	29.6%

Performance details are based on bid to bid, net of income reinvested as at 31.10.2006.

To find out more about these funds, and to see the fund managers' latest reports, use the FundPicker in the Research section of our website. Click on the 'by manager' option, select your chosen manager from the drop-down box and click go. Then choose the fund itself. Then, for the latest fund report, click on the link in that fund's summary page.

All recommendations have been prepared by Sheridan Admans, The Share Centre Advice Team. All prices, yields and recommendations are as at the market close on 24/01/07. The Share Centre's advice on Funds is restricted to those funds available via the Cofunds trading platform.

Individual Company shares

When it comes to the individual shares part of the investment model, the lowest risk entry point has always been recognised as companies in the FTSE 100. However, you should always bear in mind that the Index evolves over a period of time, changing its overall make-up.

Consider, for example, that over the last 6 years technology shares have fallen out of the Index, while mining companies, on the back of booming commodity prices, have dramatically increased their presence. Yet, because of the volatility and cyclical nature of the sector, individual mining groups can't be classed as low risk. Other 'big names' have gone from the Index due to take-over activity – companies like P&O, Abbey National & BAA – all of which have to be replaced. Today, some 80% of the make-up of the overall value of the FTSE100 comes from just 5 sectors – Banking, Mining, Oil & Gas, Pharmaceuticals, and Telecoms (fixed and mobile).

So, if you're looking to the Footsie to form the bedrock of your investment in individual shares, where should you start?

Companies involved in essential, everyday products and services, such as the water and electricity utilities and broad-based retailers often provide a solid backbone to any share portfolio. You could argue, however, that the classic 'defensive' nature of utilities has recently been undermined by the number of take-overs within the sector. The share prices of the remaining companies have climbed to all-time highs, potentially increasing the level of risk. There is without doubt an appetite for the assured cash flow that utilities provide, and it's fair to say that a growing number of analysts agree it's hard to justify the current prices. Despite this, get your timing right, buying at the right price, and these sectors should still provide a strong base on which to build your individual holdings.

To extend your scope, whilst still staying within a lower risk profile, your next ports of call should be into the banks, pharmaceuticals, tobacco and beverages sectors.

Move on up to the intermediate, 'medium risk' level, and you've an increasing choice, including the remaining FTSE100 companies, dominated by the mining sector.

The majority of shares in the FTSE250 would also fit into this 'medium risk' category. Still relatively large companies, it is these shares that have seen some of the biggest gains over the last 3 years, helping push the 250 Index to record levels in 2006.

One noticeable difference between the FTSE250 compared to the FTSE100, is that companies here generally have less international exposure. When it comes to the consideration of risk, you can play this one of two ways: some argue that having the majority of profits coming from the UK provides for less risk, while others (including us) favour having fingers in as many regions as possible.

Finally, at the higher end of the risk scale you find smaller companies and AIM-quoted shares. These tend to be more volatile and less liquid than their larger cousins, factors that generally lead to wider bid/offer spreads.

The AIM market has seen considerable growth over the last 10 years, partly because companies don't have to comply with the same stringent requirements of the main market. Often, private investors don't get a look-in as part of the flotation, having to wait until the shares start trading, so do pick your time and use stop-loss limits – that early flush of success isn't always carried through.

One of the fastest growing sub-sectors within AIM is small mining and exploration groups, many of which are based abroad but have chosen to list in the UK. Because their prospects include a significant amount of 'hope' value, such companies will represent the very highest level of risk.

Equally classified as higher-risk, though as a result of different factors, are shares in overseas companies. Household names like Volvo, Coca Cola and Johnson & Johnson are big names and big companies. The additional risk they bring for investors comes from the fact that the majority of their earnings are from overseas. So you face the added risk of changes in exchange rates. Over recent months, for example, the fall in the US$ would have had a big impact on the sterling value of dividends from US shares

At a glance

3 ways to invest in equities:

ETFs – track the markets.

Traded like shares, act like index-trackers.

Broad choice of investments, including gilts, equities and property, in the UK and overseas.

Now encompass ETCs to invest in commodities.

Funds – ready-made portfolios.

Wide spread within any one fund.

Broad choice of investment styles.

Professionally-managed.

Shares – individual shares for total control.

Choose the individual investments that meet your aims.

In general, the smaller the company, the higher the risk.

Look for a spread across market sectors to balance your holdings.

And when the companies you invest in are smaller ones, it's often harder to find reliable research and analysis, harder to track and compare performance, and harder to follow the news that affects the share price. True, most big UK names also trade globally, but as 'home market' companies they are well-researched, much commented upon and regularly feature in the UK business finance pages.

That's not to say you shouldn't venture outside these shores – far from it – but you need to do so with your eyes open. That's why we see overseas shares as being more appropriate for investors as they move up the experience ladder and once they've built a balanced portfolio. And it's also why, in general, we'd advise investing in market trackers and funds before moving into individual overseas shares.