Discretionary Management

AVELLEMY

Important Information

The content of this brochure should not be deemed as investment advice. The purpose of this document is to provide generic information to Ascot Lloyd Clients via their Ascot Lloyd Financial Advisers who are authorised by the Financial Conduct Authority.

It is the responsibility of the Ascot Lloyd Financial Adviser to ensure that the final client selection decision is based on a full understanding of the client's needs and circumstances which should be carefully considered and evaluated before refining and agreeing any final client specific recommendations.

No section of our brochure, reporting or data should be considered a client specific, or a personal client, recommendation.

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Why Avellemy?

Avellemy was launched to provide risk targeted, platform-based discretionary model portfolios for Clients, via three different sets of model portfolios – Active growth, Passive growth and Income. Importantly the mandates for each of those models are personalised to each client's risk appetite.'

We achieve this through the application of Avellemy's key principles.

Avellemy's Key Principles

1.

We only use proven experts to help us develop, maintain and provide consistency through all of the Avellemy investment solutions.

Our method of portfolio construction uses Dynamic Planner's industry leading risk profiling and strategic asset allocation technologies, which are designed to optimise client returns for their individual risk profile.

We then employ the services of Parmenion Investment Management (PIM) to provide expert investment fund due diligence. They provide a dedicated Investment Management team to Avellemy and deliver the highest quality of quantitative and qualitative due diligence via a 'Three Stage Fund Filtering Process' to find the best funds for our models from the universe of around 13,000 available.

Finally in addition to Avellemy's in-house Investment Manager, Steven Lloyd, we also use the Investment Management services of Albemarle Street Partners, to provide further oversight and expertise to the models. We feel that this independent Investment Manger oversight gives us additional experience and checking to ensure we provide the best models possible.

2. Managing risk & reward

Avellemy hold a firm belief that risk and return are inextricably linked. The priority is on meeting the expectations set by Ascot Lloyd Financial Advisors in relation to their clients' investment outcomes.

We ensure that our client-agreed investment mandates are delivered to the prescribed level of risk, by managing the volatility of portfolios. Both the client and their Adviser can have complete confidence in their risk adjusted returns through changing market conditions, and in varying strategies and investment styles.

3. Ongoing oversight & reviews

Clients trust us implicitly with their hard earned savings and therefore ongoing oversight and reviews are hugely important.

The Avellemy Investment Committee (AIC) has the responsibility for the control, governance and oversight of all our model portfolios.

Following the input from both Dynamic Planner and PIM the proposed model portfolios are reviewed and signed off by the AIC. The committee is made up by a number of internal and external independent experts to ensure that the models are managed to the appropriate mandates. The AIC monitors ongoing performance and if necessary challenges both the asset allocations provided by Dynamic Planner and the fund research by PIM where appropriate.

4. Provision of keenly priced investment solutions

One of the key drivers for launching Avellemy was that we felt many of the existing providers of platform-based discretionary models were charging a high fee for their services.

So due to the scale that Ascot Lloyd brings, we felt able to provide a high quality professional service for a competitive price that is designed to provide positive, risk appropriate solutions for clients.

Avellemy Model Portfolios – A Snapshot

Our investment solutions comprise of a range of investment styles that are mapped precisely across the Dynamic Planner Risk Profile (range 3-7).

Each solution, irrespective of its underlying investment style and philosophy, is subject to a consistent risk and return structure and governed by the Avellemy Investment Committee. This ensures that you can be secure in the knowledge that your investment through Avellemy has the right level of risk.

The Avellemy Active, Passive and Income models draw upon industry expertise to deliver attractive risk adjusted returns as part of a controlled and repeatable process.

The asset allocation is provided by Dynamic Planner who use a combination of historical data, forward looking stochastic modelling and investment oversight to determine the most efficient asset mix at any given level of risk.

The quantitative and qualitative research is provided by Parmenion Investment Management (PIM) who are industry leading experts in investment fund research.

Solution Summary	Asset Allocation	Investment Selection	Description
Avellemy Active	Strategic	Predominantly Active	Active models consist of predominantly actively managed funds. Actively managed funds aim to outperform a given index through superior stock selection.
Avellemy Passive	Strategic	Predominantly Passive	Passive models are made up of predominantly passively managed funds. These simply aim to replicate the performance of the index at the lowest cost.
Avellemy Income	Strategic	Predominantly Active	Income models are predominantly actively managed with the specific aim of generating an attractive and stable level of income.

Dynamic Planner Frameworks

Deciding upon the appropriate choice of asset allocation is a vital foundation of the portfolio construction process. Avellemy have selected Dynamic Planner to provide a set of long-term strategic asset allocations to deliver this.

By providing diversification across a range of differing asset classes, these allocations are designed to provide the most efficient expected long term returns for a given degree of risk, based on Dynamic Planner's independent modelling assumptions.

DT's Dynamic Planner software is an established leader in the field in the provision of investment suitability framework, with currently over £5.2 billion of assets managed with direct reference to its underlying asset and risk model.

Their process for deriving the asset allocations is predominantly quantitative, but a qualitative oversight is provided by Dynamic Planner's Investment Committee to ensure consistency within the models employed.

Expected returns are calculated by measuring the appropriate excess return expectations of each asset class above a typical risk free rate, typically using the prevailing UK Gilt gross redemption yield.

These risk premiums are calculated using domestic growth forecasts and earnings/dividend yields. Other factors such as expected corporate debt default rates are also considered for fixed interest asset classes.

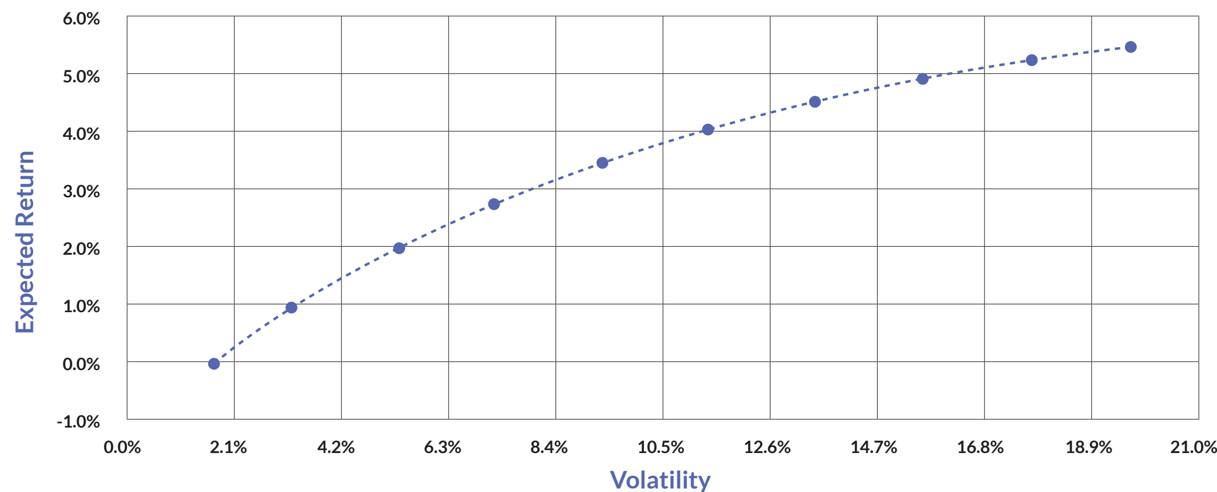
Volatility and correlation assumptions are also factored into the modelling process. Volatilities describe the potential for the asset classes to move up and down in value and are measured by using annualised standard deviations of real (after allowing for inflation) monthly returns. To estimate future volatility, Dynamic Planner includes the last 15 years of observed data available per asset class.

Correlations describe how asset classes move together with a correlation of one meaning that two asset classes will move perfectly up and down in tandem. A correlation of -1 means that the two asset classes are imperfectly uncorrelated and will move in the exact opposite direction. When creating portfolios, asset classes that are uncorrelated provide greater diversification benefits.

To estimate correlations Dynamic Planner considers the last 15 years of data available per asset class. Using this observed data, a correlation matrix across the 15 core asset classes is then created.

Modern Portfolio Theory (MPT) techniques are then applied to the assumptions to derive what is described as an efficient set of asset allocations. By this we mean portfolios that offer the highest possible expected return for a given level of expected risk, collectively these create what is described as the 'efficient frontier'. It is assumed that all investors are rational and therefore should select portfolios that reside on the efficient frontier.

The most efficient portfolio is defined for the central volatility position of each of Dynamic Planner's risk profile boundaries as shown in the chart below. Risk profiles vary from 1 (being the lowest) to 10 (being the highest) and the blue dots indicate an efficient asset allocation that is centralised within each of the respective expected risk boundaries.



When constructing these efficient portfolios, a number of constraints are considered to ensure their appropriateness for retail investors:

1. **There is no maximum allocation per asset class** other than UK commercial property which currently shall not form a position larger than 10% in any allocation due to its illiquidity constraints.

2. **Asset class changes** will not generally exceed 5% between reviews, although the Investment Committee reserves the right to exceed this in extreme circumstances.

3. **Risk profiles 3-7 represent** the most diversified portfolios and shall therefore allocate to more than one broad asset class. A broad asset class is considered: Cash, Equity, Bond or Property.

4. **There should be a smooth progression** from the broad asset class split over the increasing risk parameters. For example, the transition from a predominance in bonds to equity weightings.

5. **Given the above process constraints,** the change in efficiency (expected return per unit of risk) from a totally unconstrained set of portfolios to the final versions proposed, is kept as low as possible.

The Significance Of Risk

When it comes to making a return on an investment, it all comes down to the level of risk that a client is willing and able to take.

To put it simply, the return from an investment is the reward for accepting a certain degree of risk. Typically, this means a greater return from a riskier investment such as stocks and shares, but equally this has to be balanced with a greater potential for loss.

It is therefore, a client's capacity to accept risk that determines their long-term investment returns.

For Ascot Lloyd Financial Advisers, a core skill is understanding a client's risk appetite and agreeing an investment strategy commensurate with a level of risk they are willing to take. This can be a complex process, requiring analysis of factual information as well as personal preference.

However, this is an essential part of the financial planning process in order for a suitable investment strategy to be determined. Once the client's risk capacity has been established, it is essential that the investment strategy is in line with the client's risk preference. This can be difficult without specialist support which is why we work with both Dynamic Planner and Parmenion Investment Managers.

Managing Investment Risk

We ensure all our investment solutions offer a consistent pattern of expected risk and return.

Our unique approach to managing investment risk has led to the development of a consistent framework that applies across our range of investment solutions, allowing clients greater choice in line with their risk preferences. All our investment solutions offer a reliable pattern of expected risk and return, irrespective of the underlying differences in investment style and philosophy.

This means that having agreed a suitable risk grade, Ascot Lloyd Clients and Financial Advisers can choose from a variety of different investment styles, secure in the knowledge that the recommended portfolio will have the appropriate level of risk.

How Do We Construct Our Portfolios?

Managing risk within an investment portfolio is critical. Based on the concept of Modern Portfolio Theory, we construct our investment portfolios to reduce the overall risk of a portfolio and maximise returns for a given level of risk.

This is done by varying the exposure to risky and defensive asset classes and back testing using 20 years of historical data to help determine an optimised weighting to each asset class for any given level of risk. PIM then overlays this with their experience and a variety of techniques, including stress testing, that take into account a range of potential scenarios to ensure that each and every portfolio is suitably protected and diversified.

We define risk as the volatility of the investment – the amount by which an investment return fluctuates over time. To measure this, we primarily use the statistical measure of standard deviation.

A high standard deviation means past returns vary greatly from their average return and the returns have been volatile. A low standard deviation means returns have generally been within a narrow range around the average return.

Through the use of historical analysis, it is possible to see how varying the exposure of a portfolio to different asset classes can create a range of risk/return trade-offs. By using benchmarks for a broad range of investment classes, a range of portfolios using different combinations of asset classes can be plotted and a risk map for all PIM investment solutions defined.

For each Avellemy investment solution and risk grade, it is then possible to see the average annual return, the possible volatility and maximum gains and losses that have historically been generated.

This data can be used to obtain feedback from a client to ensure they are comfortable with the recommended portfolio's pattern of return.

Fund Research

PIM undertakes rigorous research for each fund included in the Avellemy portfolios. The objective is to select funds that will provide favourable risk adjusted returns over the long term.

The research of these funds is divided into two stages: quantitative and qualitative, alternatively known as 'hard' and 'soft' analysis.

The quantitative analysis measures raw data which includes the risk/return performance of the collective fund, downside risk management and fund manager skill.

The qualitative element involves meeting the fund manager face-to-face in order to understand the investment process that has produced the favourable risk adjusted performance which PIM has identified.

Combining both the quantitative and qualitative research provides a complete analysis of a fund. It is only after such a thorough process that a fund may be included in our portfolios.

Following inclusion, the subsequent performance of a fund is continually monitored including meetings with the fund managers at least annually.

Quantitative Screening

The quantitative screening process involves three distinct steps of analysis each of which is taken in turn before proceeding to the next stage:

1. Risk/return analysis
2. Examination of downside risk
3. Measurement of fund manager skill

The risk/return analysis involves examining each Investment Management Association (IMA) sector e.g. Global Growth and UK Equity Income, and placing all of the funds within that sector into one of four quadrants, depending upon their three year risk adjusted performance. Those funds placed into the top left quadrant of figure 1. (see page 12) are of most interest because they have above peer group return with below peer group risk over the past three years. These funds meet our criteria of favourable risk adjusted returns.

The second step is to examine the funds for downside risk management in order to minimise the risk of capital loss and ensure capital preservation.

Qualitative Screening (cont)

The research of fund managers is an important part of the fund selection process. The objective of this research is to understand their investment methodology.

This broadly focuses on the following areas:

1. The fund manager and the team
2. Their investment philosophy and style of investment
3. The buy/sell discipline for including investments in their funds
4. The economic cycle and how that affects their investment approach if at all

Clearly there is no 'right' answer to any of the above. However, it is the logic and consistency of the approach that is important.

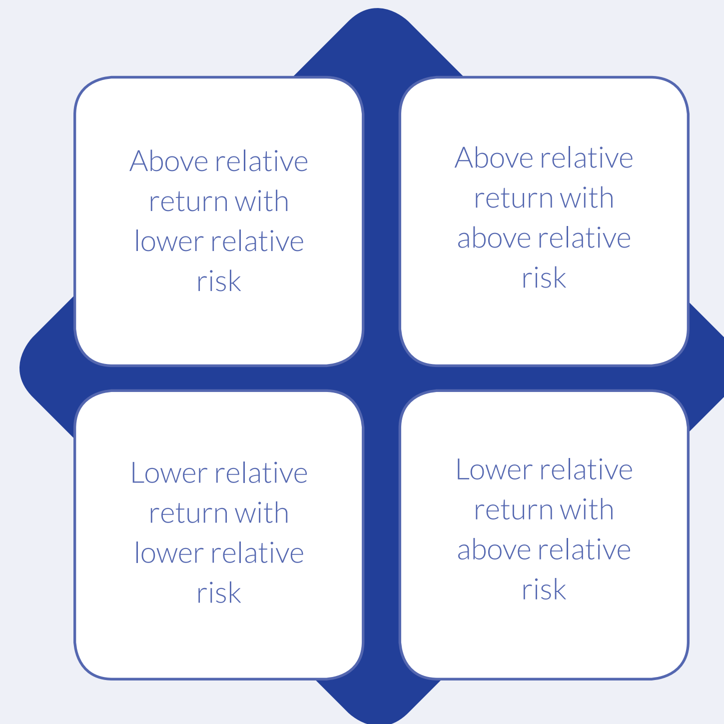


Figure 1. The four quadrants

The purpose of the solution

The primary objective of the Avellemy Income Portfolios is to deliver investors a stable income in line with their capacity for risk, regardless of the market environment. To meet this objective, whilst complying with attitude to risk and capacity for loss suitability requirements, we offer 5 risk graded portfolios each specifically designed to generate an attractive level of income.

Why is there demand for an income solution and who does it relate to?

As the UK population gets older and the average pension scheme faces funding pressures, looking to the state for a retirement income is becoming increasingly questionable. This is compounded by the fact that while many savers have much of their capital locked-up in property, their savings elsewhere are earning meagre returns with government bonds yields and high street interest rates as low as they are. As a result the search for a reliable income for retirees, savers and investors alike is becoming ever more pressing.

There are other investors who also require an annual income such as those who have received a settlement from a personal injury pay-out or trustees responsible for meeting their fiduciary duties to their trust benefactors. Regardless of the reasoning, all tend to share common objectives of targeting a stable and reliable annual income to help meet on-going liabilities.

How do the Avellemy Income Portfolios work?

An investor will discuss with their adviser an appropriate portfolio based around Dynamic Planner's asset allocation.

PIM start with a quantitative screen which identifies those funds which have consistently outperformed their peers with less volatility (a proxy for risk) over the past three years. Once a short list of funds has been identified, PIM then conduct full and thorough due diligence in order to understand the quality of the manager and team, the investment philosophy, process and risk controls. This will often involve interviewing the fund manager in person.

Should a fund pass this rigorous due diligence process, the level of income that has been produced in the past, how stable the income stream has been and what it might look like in the future is also considered. Only funds which look attractive relative to their peers on all these basis will be included in the Avellemy Income Portfolios.

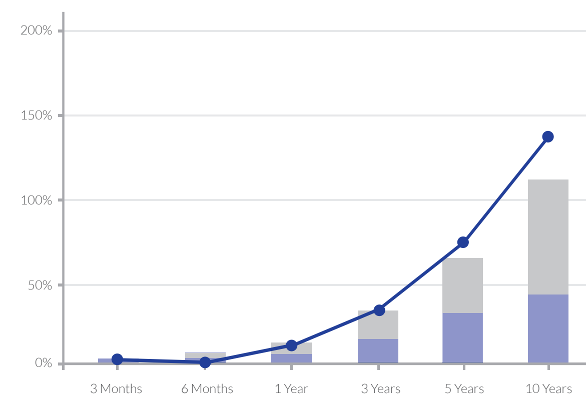
What are the risks?

1. The greater the potential of a capital loss if a higher risk grade is selected in the pursuit of a higher yield.
2. A fixed monthly withdrawal can lead to capital being eaten into if it exceeds the natural income generation of the portfolio.
3. Unfavourable market conditions will reduce the total income generation capability of a portfolio impacting financial planning.
4. Reduced total returns (capital appreciation plus income yield) from a portfolio if an annual income is withdrawn. For example in Figure 2. (right), the total return of a simulated portfolio shown in blue is reduced to that of the purple bars if the grey bar representing dividend and interest income is withdrawn.

Figure 2. The effects of income

Withdrawal on total return

Data is sourced from FE Analytics. Portfolio returns are calculated on a bid to bid basis, based on the performance of the appropriate market indices, over a 20 year period to 31st December 2012. As data is based on indices, the effect of taxation and fees on portfolio returns have been excluded.



Maximiser Funds

A Maximiser Fund is designed to deliver a targeted annual income greater than their sector peer group average. They achieve this by issuing financial options, in return for a payment, as part of their investment process to generate additional income. These strategies reduce the fund's volatility by diluting their sensitivity to market movements, typically limiting growth potential if markets rise and mitigating the downside return if markets fall.

To maintain a balance between the target yield and the portfolio total return, the extent of exposure to Maximiser Funds is limited to 35% of the portfolio value. The portfolio will otherwise only be invested in collective investments and cash.

Key Characteristics

1. This solution is designed for investors seeking an annual income.
2. 5 risk graded fund based portfolios based upon Dynamic Planner's asset allocations.
3. The portfolios link to Dynamic Planner's standard Attitude to Risk Questionnaire.
4. Fund selection is consistent with PIM's standard investment selection disciplines.
5. Active and Passive funds are used in varying combinations as market conditions alter.
6. Fund choices are made to earn a stable income throughout the year where possible.
7. A 35% limit on exposure to Maximiser Funds.

Factors Affecting Income

1. Funds for the Avellemy Income Portfolios are chosen to provide an attractive level of income relative to cash deposits and their peer group. It should be noted that the amount and frequency of income withdrawn can impact the capital value of a portfolio.
2. Yields will vary over time, this means income is variable and is not guaranteed. The pattern of income receipts will vary over time, reflecting the constituent funds in each portfolio.
3. Income will be supplemented by monies taken from capital when actual yields are not high enough to meet a required level of withdrawal, and in that situation capital erosion may occur.
4. Charges are applied to the cash/trading balance with additions taken from capital if there are insufficient monies available, therefore potentially eroding portfolio capital over time.
5. Investors are able to select either fixed or natural monthly portfolio withdrawals, with the amount of natural being dependent on the yield generation of the underlying investments held.

Passive Portfolios – Additional Due Diligence Process

Overview of the due diligence process

The first-stage of due diligence is to rank funds by overall holding cost, tracking error and performance difference, all of which have a direct impact on expected return relative to index. In each case the fund with the lowest result is preferred.

Overall holding cost is calculated assuming a three year holding period, tracking error is calculated over one and three years and performance difference is calculated over each of the three latest discrete 12-month periods. Rankings by cost and tracking error are double weighted and then the overall rank based on the three metrics is calculated.

For the purpose of minimising risk, each fund is then further scrutinised for their method of replication, fund size and stock lending policy. In general our preference is for full replication, large fund size and no or strictly controlled stock lending.

Details of the due diligence process

Defining a 'Growth Asset'

Clearly the Ongoing Charges Figure (OCF) is a significant part of the cost but there are also costs associated with buying into and subsequently selling funds.

Some are explicit, such as the bid/offer spread on dual-priced funds or Preset Dilution Levies, while others are more hidden, namely the amount by which the price of a single-priced fund is swung for significant trades.

We assume a three year holding period so the annual OCF has a third of the round-trip costs associated with buying and selling the fund added to provide a per annum measure of the overall holding cost. Because cost has such a direct impact on returns relative to index, we double-weight the ranking when calculating the overall rank of funds in each sector.

Tracking error and performance difference

Tracking error and performance difference are linked but not identical. In the same way that volatility is a measure of the variability of absolute performance, tracking error is a measure of the variability of performance difference.

A fund's tracking error is a function of how tightly its price moves with index moves and is calculated as the standard deviation of that performance difference. For example, two tracker funds may return 9.8% against an index up 10%, giving a performance difference of -0.2%. However their route to that figure may be different. One fund may have higher monthly deviations from the benchmark owing to its replication strategy e.g. stratified sampling, than another fund that uses full replication.

We would prefer the fund with the lower deviation from benchmark, i.e. the one with lower tracking error[1]. We rank based on both one year and three year tracking error so that tracking error is also double-weighted in establishing the rankings.

Funds are ranked by their performance difference because it is possible for a fund to very smoothly but progressively lose ground against its index, while another (perhaps one with a smarter approach to dealing with quarterly index changes) might have marginally higher tracking error but a better overall performance (for example if their approach allows them to avoid being forced to trade with the herd on the day of index changes).

[1] NB – we calculate the tracking error based on the monthly performance data from FE for each fund and its index, rather than using FE's own tracking error figures as these are sometimes calculated against the IMA sector rather than the fund's actual benchmark.

Method of replication

There are four replication methods that tracker funds use to track their index:

1. Full replication means holding every stock at the same weighting as they are held in the index. The fund must by definition return the same as the index, less associated costs.
2. Stratified sampling means the index is divided into sectors or groups with a representative sample of stocks chosen from each that will mirror the performance of the index. The fund's return will be similar to that of the index provided the sampling is well done, with slightly lower associated costs.
3. Optimisation means using models that are based on historical data to track the index. The fund manager's decisions have a larger impact on fund returns, meaning that these may deviate from that of the index.
4. Derivatives over an index can be held instead of buying the stocks directly. Using derivatives introduces counter party risks and costs that are not always apparent.

We prefer full replication to stratified sampling. Both are preferred to optimisation and derivatives.

Fund size

There are a number of advantages for a large passive fund;

1. It is easier to fully replicate the index.
2. It is more likely to have two-way cash flows, allowing them to be netted off and so reduce overall transaction costs.
3. Able to negotiate more competitive transaction costs.

Larger funds are preferred to smaller funds.

Stock lending

Stock lending by tracker funds creates a small income for the fund because a fee is paid by the borrower (usually an active fund seeking to sell the stock short). Tracker funds are ideal 'stock lenders' owing to their long term holdings in companies. The fee is shared between the fund and the fund management company. In return for borrowing the stock from the lender, the borrower will provide collateral to the stock lender. The risk therefore for the tracker fund is that the borrower will default on the return of the stock and the collateral will not cover the costs of replacing the lent stock.

Each fund management company will have procedures in place for its stock lending which include examining the credit worthiness of the borrower, the monitoring of the value and volatility of the collateral versus the stock lent and the percentage of the fund that may be lent.

It should be noted that some passive fund providers have a policy not to lend stock at all (Fidelity), while some do so only in particular circumstances (Legal & General, Vanguard). Funds that do not lend are preferred to those that do, although provided the risk controls are satisfactory, we will hold funds that lend stock.

Disclaimer

This document is only suitable for professional distribution. Past performance should not be taken as a guide to future returns. The value of investments and the income you earn from them may go down as well as up and you may not get back the full amount invested. The views and opinions expressed in this document are those of Avellemy, they should not be taken as a personal recommendation to buy or sell.

Investment Committee Members – External Staff Biographies

Peter Dalgliesh
PIM Managing Director

Peter's remit encompasses a broad range of investment management responsibilities, covering both general management and strategy. He conducts in-depth fund analysis and top down market research in order to identify development opportunities for both products and services. He is meticulous when monitoring and adjusting risk-graded portfolios, to ensure they are in sequential alignment with their risk profile and guided by client suitability.

Peter holds an MA Honours in Geography and Economics from Edinburgh University. He embarked on his financial career completing the Graduate Trainee Programme at Barings Asset Management before focusing on the Asia Pacific and Emerging Markets asset classes. He was responsible for managing money at Jupiter Asset Management, Gartmore and F&C.

Latterly Peter was a Director of Emerging Markets at F&C responsible for the £330m High Alpha Asia Pacific ex Japan platform. Peter holds the AIIMR qualification.

Simon Brett
PIM Director & Chief Investment Officer

Simon's polished approach to investment management helps him guide and manage the team's quantitative and qualitative investment process. Simon is responsible for all investment solutions, ensuring that every investment is fit for purpose. Having been in the industry for over 26 years his extensive experience and accumulated knowledge combine to offer an industry leading investment management capability as vindicated by inclusion in the Top 100 Wealth Managers for 2012.

Simon holds an MBA from the University of Bradford and studied Economic Geography in London with a brief spell at George Washington University in the US. He started his career at County NatWest, and has held a number of prestigious positions, most notably he was head of the mid cap equity team at Equitable Life, managing £1.5bn. He is a fellow of the Chartered Institute for Securities and Investment.

Harry Garrett

PIM Investment Manager

As an Investment Manager, Harry shares responsibility with the wider PIM team in monitoring and managing the diverse range of investment solutions available on the Parmenion platform. Responsibilities include sitting on the tactical asset allocation committee, fund analysis across all asset classes and the alignment of all Risk Grade portfolios in all solutions.

Harry has a first class degree in Accounting and Business from Bournemouth University. After graduating, Harry began his career at Novia Financial, where he evolved his knowledge of the investment management industry. Having joined PIM in July 2014 he has recently completed his professional investment qualifications becoming a CFA Charterholder.

Tony Yousefian

Albemarle Street Partners Investment Manager

IIMR Investment Management Certificate
Financial Planning Certificate 1, 2 and 3.

Tony has more than 20 years' experience in Asset Management with responsibilities for both Private Client Portfolio and Funds of Funds. He has extensive experience of analysing funds and fund managers in all the major IMA sectors. With a deep knowledge of many asset classes, including long only collectives, property, equities, exchange traded funds, currencies and commodities.

He is also a respected media commentator with high visibility and a leading industry profile, particularly in the multi-manager/funds arena. Importantly, he also has a highly developed industry-wide network of contacts.

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