SCOTT-MONCRIEFF
EDINBURGH AND GLASGOW

ASSET ALLOCATION 1
The Key to Portfolio Construction

Since the introduction of the Sandler Report in July 2002, the importance of asset allocation in portfolio construction has been brought to the attention of financial advisers and the public at large.

Many UK investors have paid too much attention to individual fund manager selection and market timing within a single asset class. Yet research suggests that the biggest determinant of variance in investment returns is the basic principle of asset allocation. This aspect of portfolio construction has often been overlooked or sometimes neglected altogether.

Asset allocation can be described as:-

"The process of apportioning an investor's capital across the major asset classes, such as equities, fixed interest, property and cash. This apportionment is influenced by the long-term objectives and risk profile of the client."

This is not simply a matter of diversification, although the spreading of risk between different types of investment is clearly important. Investors have long realised that a failure to diversify investments in a portfolio can lead to greater volatility, due to the reliance of the portfolio on the returns or losses of only a few investments. The recent technology boom in 1999/2000 has shown that many investors have learnt to their cost, that investment diversification should mean much more than simply holding a range of different UK equities or a range of equity-based funds.

Asset allocation aims to provide investors with an optimal combination of investments, with the potential to give the return they require with the lowest possible risk, or volatility. Diversification is properly achieved by combining a range of assets with relatively low correlation in a single portfolio.

Most investors would like to have the certainty of high returns for minimal risk. The reality is that there is usually a close relationship between risk and return. Over time, financial markets have tended to reward higher-risk investors with higher returns. However, over shorter time periods, risky assets like equities and bonds can experience considerable volatility. A sound asset allocation process should therefore be based on finding a balance between three critical variables, Risk, Return & Time horizon and how they relate to each client.

Scott-Moncrieff Life & Pensions Ltd has devised a Risk Profile Questionnaire to help determine more accurately, each client`s attitude to risk and financial objectives. The questionnaire contains many questions relating to this subject matter, but in essence, there are four main questions that every investor must consider:-

1. What returns do you expect to receive ?

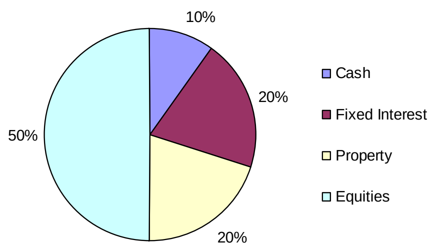
2. How long can you stay invested ?

3. What sort of risks are you willing to take ?

4. How much volatility can you comfortably accept ?

Once these questions have been answered, it's possible using a sophisticated range of portfolio modelling techniques, to produce an asset allocation model that best suits your requirements. These techniques have, up until now, been used almost exclusively by institutional investors and have not been available to the retail investor.

For example, the pie chart below illustrates the asset allocation for a "Moderate" investor looking to achieve long-term growth over a 5 to 10 year period. (SML&P Model Portfolio No: 3)



Having established the ideal asset allocation for your portfolio, your Scott-Moncrieff consultant will make specific fund recommendations from a range of sector funds that have been carefully screened to meet your requirements and fulfil the objectives of the portfolio. All of these sector funds have been pre-selected from the leading fund management houses in the UK and have been chosen because they meet our strict criteria determined using a combination of past performance, volatility, risk/return and other measures.

Portfolio Re-balancing: Over time, as the funds within each asset class perform differently to each other, the balance between the funds and therefore the asset class proportions may change. This would mean that your portfolio may start to become more or less risky than you chose at outset. It is important therefore, that re-balancing of your asset allocation should take place regularly.

It is recommended that this type of review takes place, at least annually.