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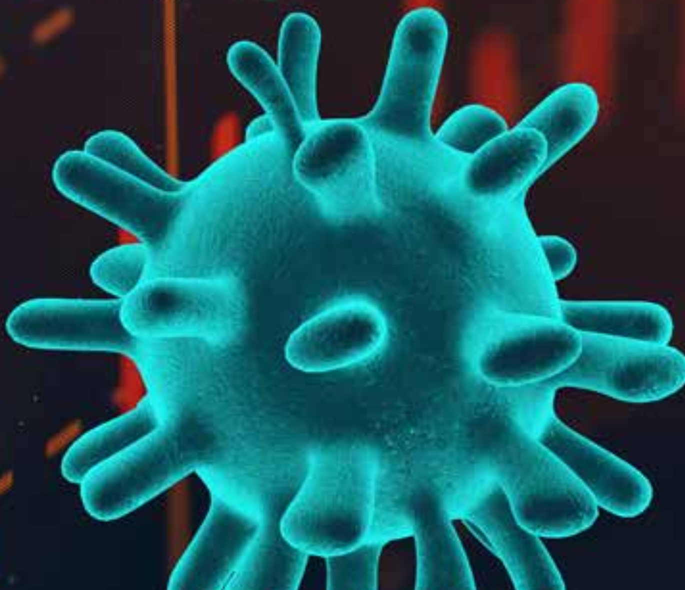
GUIDE TO

INVESTMENT DIVERSIFICATION

INVESTING IN AN UNPREDICTABLE WORLD



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GUIDE TO

INVESTMENT DIVERSIFICATION

Investing in an unpredictable world

In our *Guide to Investment Diversification*, we consider why diversification is an important part of investing. In practical terms, diversification is holding investments which will react differently to the same market or economic event. Generally speaking, there are four broad asset classes: cash, fixed interest (bonds), property and shares (equities).

Since performance in any one asset class can be unpredictable depending on shifts in the market, investing across several asset classes can provide greater diversification potential. Therefore, if one asset class performs favourably, it can potentially offset another that is performing less favourably, providing more balance to your portfolio when market shifts occur.

Range of assets

One of the most effective ways to manage investment risk is to spread your money across a range of assets that, historically, have tended to perform differently in the same circumstances. This is called 'diversification' – reducing the risk of your portfolio by choosing a mix of investments.

In the most general sense, there are many adages: 'Don't put all of your eggs in one basket', 'Buy low, sell high', and, 'Bears and bulls make money, but pigs get slaughtered'. While that sentiment certainly captures the essence of the issue, it provides little guidance on the practical implications of the role that diversification plays in a portfolio. And, ultimately, there is no such thing as a 'one-size-fits-all' approach.

Your financial goals and what your attitude to risk is

Different investors are at different stages in their lives. Aside from dividing your investments across different asset classes, there are a number of other factors to take into account as well, in particular what life stage you're at (such as early in your career or close to retirement), what your financial goals are, and what your attitude to risk is.

Under normal market conditions, diversification is an effective way to reduce risk. If you hold just one investment and it performs badly, you could lose all of your money. If you hold a diversified portfolio with a variety of different investments, it's much less likely that all of your investments will perform badly at the same time. The profits you earn on the investments that perform well offset the losses on those that perform poorly.

ASSET CLASSES	MAIN ADVANTAGES	MAIN RISKS
Cash	Relatively secure	May lose value if the interest rate doesn't keep up with inflation.
Bonds	Regular income	The bond issuer is sometimes unable to repay in full.
Shares	Regular income and opportunity to grow over time	Share prices can go up and down. A fall in share price will reduce the value of your investment
Property	Stable and regular income, potential to grow over time	Property prices can fall reducing the value of your investment. Property transaction take a long time, so your money may be tied up for longer than you want it to be.

Spreading your investments within asset classes

While it cannot guarantee against losses, diversifying your portfolio effectively – holding a blend of assets to help you navigate the volatility of markets – is vital to achieving your long-term financial goals whilst minimising risk. Although you can diversify within one asset class – for instance, by holding shares (or equities) in several companies that operate in different sectors – this will fail to insulate you from systemic risks, such as international stock market volatility.

As well as investing across asset classes, you can further diversify by spreading your investments within asset classes. For instance, corporate bonds and government bonds can offer very different propositions, with the former tending to offer higher possible returns but with a higher risk of defaults, or bond repayments not being met by the issuer.

There are four main types of investment, known as 'asset classes'. Each asset class has different characteristics and advantages and disadvantages for investors.

Diversify cross assets valued in different currencies

Effective diversification is likely to allocate investments across different countries and regions in order to help insulate your portfolio from local market crises or downturns, as we've been seeing recently. Markets around the world tend to perform differently day to day, reflecting short-term sentiment and long-term trends.

"Warren Buffett, the American investor and philanthropist, puts it very succinctly: 'Our favourite holding period is forever.' Over the long term, investors do experience market falls which happen periodically."

Warren Bufett, the American investor and philanthropist

There is, however, the added danger of currency risk when investing in different countries, as the value of international currencies relative to each other changes all the time. Diversifying across assets valued in different currencies, or investing in so-called 'hedged' assets that look to minimise the impact from currency swings, should reduce the weakness of any one currency, significantly decreasing the total value of your portfolio.

Creating a more effectively diversified portfolio

Achieving effective diversification across and within asset classes, regions and currencies can be difficult and typically beyond the means of individual investors. Individual funds often focus on one asset class, and sometimes even one region, and therefore typically only offer limited diversification on their own. By investing in several funds, which between them cover a breadth of underlying assets, investors can create a more effectively diversified portfolio.

Multi-asset funds hold a blend of different types of assets designed to offer immediate diversification with one single investment. Broadly speaking, their aim is to offer investors the prospect of less volatile returns by not relying on the fortunes of just one asset class.

Take a long-term view (typically ten years or more)

Multi-asset funds are not all the same, however. Some aim for higher returns in exchange for assuming higher risk in their investments, while others are more defensive, and some focus on delivering an income rather than capital growth. Each fund will have its own objective and risk-return profile, and these will be reflected in the allocation of its investments – for instance, whether the fund is weighted more towards bonds or equities.

As we've seen recently, stock markets can be unpredictable. They move frequently – and sometimes sharply – in both directions. It is important to take a long-term view (typically ten years or more) and remember your reasons for investing in the first place.

Be prepared to view the occasional downturns simply as part of a long-term investment strategy, and stay focused on your goals. Historically, the longer you stay invested, the smaller the likelihood you will lose money and the greater the chance you will make money. Of course, it's worth remembering that past performance is not a guide to what might happen in the future, and the value of your investments can go down as well as up.

Emotions overcome sound investment decisions

Give your money as much time as possible to grow – at least ten years is best. You'll also benefit from 'compounding', which is when the interest or income on your original capital begins to earn and grow too. There will be times of market volatility. Market falls are a natural feature of stock market investing. During these times, it is possible that emotions overcome sound investment decisions – it is best to stay focused on your long-term goals.

Resist the temptation to change your portfolio in response to short-term market movement. 'Timing' the markets seldom works in practice and can make it too easy to miss out on any gains. The golden rule to investing is allowing your investments sufficient time to achieve their potential.

Why you're invested in the first place

Warren Buffett, the American investor and philanthropist, puts it very succinctly: 'Our favourite holding period is forever.' Over the long term, investors do experience market falls which happen periodically.

Generally, the wrong thing to do when markets fall by a reasonable margin is to panic and sell out of the market – this just means you have taken the loss. It's important to remember why you're invested in the first place and make sure that rationale hasn't changed. However, it is important to keep in mind that diversification does not guarantee a profit or ensure against a loss. ■

SHAPE YOUR PERSONAL FINANCIAL JOURNEY

In these extraordinary times, many aspects of our daily lives are being disrupted. We are here to help you shape your personal financial journey. We will understand your ambitions and support you to achieve them through our long-term thinking and expertise borne of experience. To find out more, please contact us.

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THE VALUE OF INVESTMENTS AND INCOME FROM THEM MAY GO DOWN. YOU MAY NOT GET BACK THE ORIGINAL AMOUNT INVESTED.

READY TO START A CONVERSATION?

We'll help you select the right solution to save and invest for your future, taking into consideration everything from your risk appetite to the term you want to invest for.

If you would like to review your situation or discuss the options available, please contact us for further information – we look forward to hearing from you.

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