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FACTSHEET

What's in your basket?

Diversifying your assets helps spread risk by lessening the potential for losses

Most investors are used to hearing the term 'diversification' – but it has a broader meaning than many realise. Diversification is the process of investing in areas that have little or no relation to each other. This is called a 'low correlation'.

SPREADING INVESTMENT RISK

You can also invest in assets that have a negative correlation. This means that the assets will move in opposite directions to each other. Diversifying your assets helps spread risk because you're lessening the potential for losses. If you had all of your money invested in one asset, sector or region and it began to drop in value, your investments would suffer.

By investing in assets that aren't related to each other, while one part of your investment portfolio is falling in value, the others aren't going the same way. Some assets may actually go up in value when others could decrease. It is also possible to diversify through investing in different markets, countries, companies and asset types.

DIVERSIFY BY ASSETS

Having a mix of different asset types will spread risk because their movements are either unrelated or inversely related to each other. It's the old adage of not putting all your eggs in one basket.

Probably the best example of this is shares, or equities, and bonds. Equities are riskier than bonds and can provide growth in your portfolio, but, traditionally, when the value of shares begins to fall, bonds begin to rise, and vice versa.

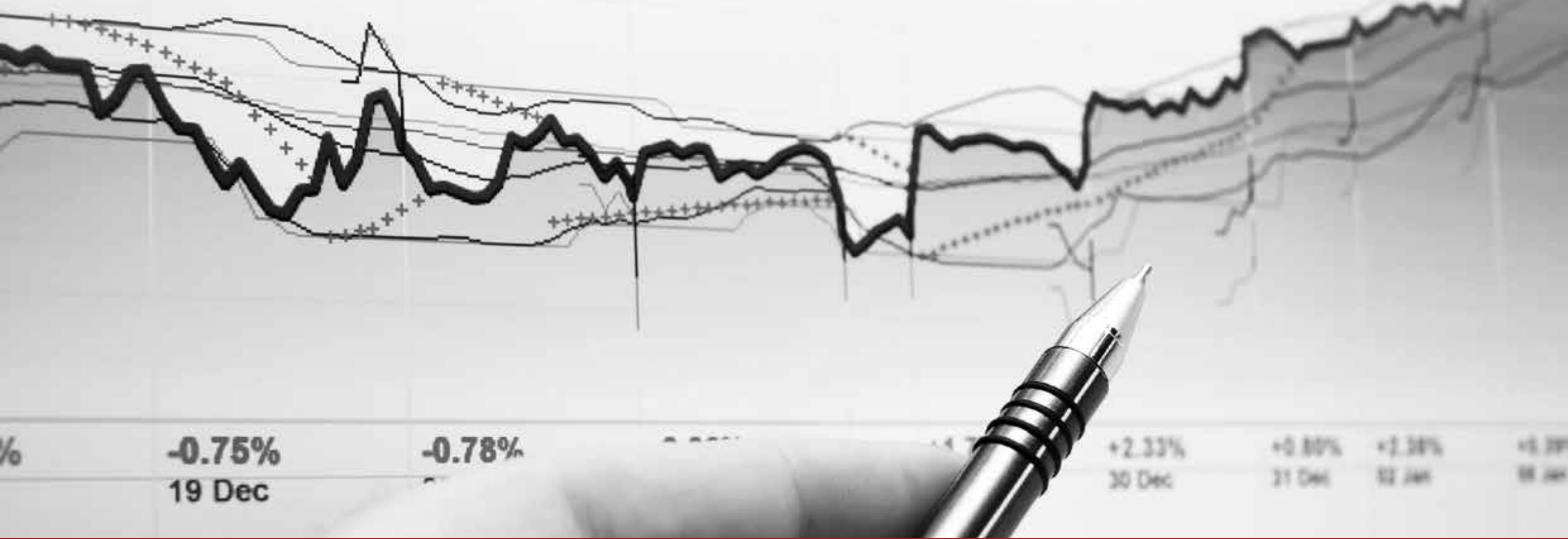
Therefore, if you split your portfolio between equities and bonds, you're spreading the risk, because when one drops, the other will rise to cushion your losses. Other asset types, such as property and commodities, move independently of each other, and investment in these areas can spread further.

DIVERSIFY BY SECTOR

Say you held shares in a UK bank in 2006. This investment may have been very rewarding, so you decide to buy more shares in other banks. When the credit crunch hit a few years later, sparking the banking crisis, the value of your shares in this sector (financials) would have tumbled.

So once you've decided on the assets you want in your portfolio, you can diversify further by investing in different sectors, preferably those that aren't related to each other.

If the healthcare sector takes a downturn, this will not necessarily have an impact on the precious metals sector. This helps to make sure your portfolio is protected from dips in certain industries.



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DIVERSIFY BY GEOGRAPHY

Investing in different regions and countries can reduce the impact of stock market movements. This means you're not affected by the economic conditions of just one country and one government's fiscal policies.

Many markets are not correlated with each other – if the Asian Pacific stock markets perform poorly, it doesn't necessarily mean that the UK's market will be negatively affected. By investing in different regions and areas, you're spreading the risk that comes from the markets.

However, you need to be aware that diversifying in different geographical regions can add extra risk to your investment.

Developed markets like the UK and US are not as volatile as some of those in the Far East, Middle East or Africa. Investing abroad can help you diversify, but you need to be comfortable with the levels of risk that come with them.

DIVERSIFY BY COMPANY

Spread your investments across a range of different companies. The same can be said for bonds and property. One of the best ways to do this is via a collective investment scheme. This type of scheme will invest in a basket of different shares, bonds, properties or currencies to spread risk around. In the case of equities, this might be 40 to 60 shares in one country, stock market or sector.

With a bond fund, you might be invested in 200 different bonds. This will be much more cost-effective than recreating it on your own and will help diversify your portfolio.

BEWARE OF OVER-DIVERSIFICATION

Holding too many assets might be more detrimental to your portfolio than good. If you over-diversify, you might not end up losing much money, but you may be holding back your capacity for growth as the proportions of your money in different investments will be too small to see much in the way of positive results.

TIME TO REVIEW YOUR CURRENT INVESTMENT STRATEGY?

If you would like to review your current investment strategy, please contact us – we look forward to hearing from you.

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