

Providing Financial Education



# Diversification – Weather the Storms

With a little consideration, a balanced, well-diversified portfolio should weather the short-term storms of stock market and property market fluctuations.

# AN INTRODUCTION TO DIVERSIFICATION

Diversification is a much used term in the financial world and one that can be employed at many levels.

Most fund managers claim their aim is to diversify risk by investing across a range of different stocks or shares, even when their universe is quite small – for example, a smaller companies manager with perhaps only 400 potential investments to choose from would suggest that his hand-picked selection of 70 offered diversification.

## **The Role of a Financial Adviser**

It is the job of your financial adviser to help you diversify your portfolio by guiding you through the range of different assets and allocating your portfolio across the different options to help you meet your objectives whilst also staying within your acceptable level of risk.

A well diversified Portfolio is more likely to smooth out the many peaks and troughs and help you meet your financial objectives over the longer term without causing too many shocks along the way.



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# THE FIRST STEPS...

When looking to invest, no matter what the asset class, there are risks.

These are predominantly made up of two aspects: market risk, the impact of economics or government changes, and investment risk, the uncertainty and volatility of returns.

Diversification can help to reduce both of these risks. Market risk cannot be eliminated but can be reduced by spreading the portfolio over a range of different asset classes, each of which reacts differently in different market environments.

By broadening a portfolio's exposure across a range of asset classes, it is likely that, at any one time, some may be rising whilst others may be falling. As a result, some of the fluctuations caused by most economic and

financial events can be smoothed out as the two movements, to an extent, cancel each other out. The same is true of investment risk.

For example, whilst all shares have a similar exposure to sentiment in the stock market on which they listed, the investment-specific risk varies from company to company – that is the shares in each do not move in exactly the same direction by exactly the same amount, at the same time.

In the same way, therefore, there is some smoothing of returns as each share moves differently from the rest.

This all sounds like good news but you also need to consider the other side of the coin.

If you invest across different asset classes then, when one asset class is thriving, the fact your portfolio holds others asset classes as well will act to lower the return which it could have achieved. This might lead you to the question, 'how diversified should a portfolio be'?

The answer depends greatly on your attitude to risk. We can assume, quite confidently given the lessons of history, that no one person is able to accurately predict the performance of markets to the degree where they know exactly where to be invested at any point in time.

If it were possible, we would all be millionaires. Therefore we use diversification to effectively hedge our bets. The extent to which we need to do this depends on how much volatility we can deal with – how much we tend to worry or panic when the value of our portfolio starts to fall.



# SPREAD OUT YOUR EGGS OVER MANY BASKETS!



## SPREAD OUT YOUR EGGS!

So, that's the theory. In practice, once you know what you can deal with, the effectiveness of the diversification strategy depends on considering the degree of 'correlation' between various elements in a portfolio - or in simple terms how 'together' investments move - and combining them appropriately so that the overall movement is in line with your expectations.

For instance, fixed interest investments can be seen as a safe haven when markets are rough and equities are volatile. Property on the other hand, has tended to protect against inflation over the long term, whilst also not moving in line with equities. Then there is cash, which depends entirely on interest rates for its level of income, and government bonds. Each responds differently to external influences such as interest rates and inflation.

# ANY PORTFOLIO CAN BE DIVERSIFIED

However, remember that when you diversify your portfolio, risk is not the only thing that you will lower. You will also lower the level of return which you would have received if you were 100% invested in the best asset class only.

The skill comes in balancing your asset allocation so that the relative payoff matches your own attitude to risk and reward.

## Diversify within asset classes

But within each asset class there are further opportunities for diversification. Within equities, for example, the returns of some companies versus others are not related in any way.

Generally speaking there is little correlation between the performance of say biotechnology stocks and utilities such as water and electricity companies as the market forces driving these two sectors can be completely different.

However, as they are both listed on the stock market they are both subject to what affects the overall equity market, such as the impact of a government's monetary policy, or inflation, as well as overall investor sentiment.



## Diversify by geography

Geography also allows some of the impact of stock market movements to be dissipated, as you are not exposed only to the economics and government decisions of one country.

Different markets are affected by different economic and financial factors and are therefore not perfectly correlated with one another. If the Far East does badly, it does not necessarily mean European stock markets will.

Within Europe there is the possibility of even more diversification by geography as not every stock market in Europe moves with the next.

Yet, all equities can be impacted globally, particularly when investor sentiment is involved – consider the impact of the boom in telecom, media and technology stocks in the late 1990s, followed by their subsequent collapse.

The effect of this was global – although markets such as the US, which had greater exposure to these sectors, were impacted more heavily, almost all countries suffered from the somewhat depressed equity environment during the bear market of 2000 through to early 2003.

## Diversification within bonds and property

The same can go for fixed interest investments (bonds) and property.

For example, government bonds, particularly those of investment grade countries such as the US or UK, do not tend to operate in the same fashion as sub-investment grade corporate bonds, which we issued by less financially secure companies.

Within property meanwhile, even commercial property and residential property are not always correlated in the returns they offer.

The skill comes in balancing your asset allocation so that the relative payoff matches your own attitude to risk and reward.

# SO, WHAT DO YOU PUT IN YOUR BASKET?

Generally, the place to start for most investors is to consider your attitude to risk in some detail.

If you could not live with the fluctuations of the stock market and would be very worried by the sight of prices going down, then you are likely to have a very low-risk attitude to risk and low capacity for loss. For those who are extremely low-risk, cash may be the most appropriate investment.

If you are comfortable with a little movement, and are investing for the long term, you may include a small element of equity exposure.

Alternatively, if you are at the opposite end of the scale – a high-risk investor, who is perfectly happy with the ups and downs of markets – then you would most likely have the majority of your portfolio in equities.



## USING MUTUAL FUNDS

Mutual funds by their very nature already offer some diversification as they hold a number of different securities, generally in a particular market, sector or asset class.

For example, you could choose a Japanese equity, global technology, government fixed interest, UK corporate bond or North American smaller companies fund.

As mutual funds tend to hold 60 or more stocks, they offer you more diversity than if you selected just one or

**NOTE:** Property is a specialist asset class and expert advice should be sought before making a decision to invest. The value of any market or property investment can go down as well as up and you may not get back the amount originally invested.

By selecting funds, you hand over the job of stock diversification to the experts, leaving you to concentrate instead on the other main elements - asset class and geography.

If you are making your first steps into investment, or have only a small amount to invest, you can hand over even more of the decisions by targeting the broader portfolios of global equity or managed funds. Within these, not only does the fund manager diversify by type of company and their respective weightings but they also look at country weightings – and usually, some element of asset allocation as well.





# BRINGING IT ALL TOGETHER

When looking at proportions, this is where many consider simple processes such as, for example, a core/satellite approach.

Typically the core portion makes up the largest part of the portfolio, is relatively less volatile and is designed to provide a solid base on which to build. The satellite investments then add the spice to the portfolios by taking smaller positions in higher-risk regions, asset classes or sectors.

For a lower or medium-risk investor, their core portfolio might be concentrated in cash, bond and property funds or perhaps an equity fund linked to larger, highly regulated stock markets, such as the US or the UK. The satellite element may then access varying high yield bond, equity or sector exposures at lower weightings.

## FINALLY – BEWARE THE LATEST FASHIONS

Today there are many more esoteric investment choices than ever before, capturing the attention of potential investors but also creating unpalatable risks if bought alone.

Some of these products include debt obligations, gold, resources, Brazil, Russia, India and China as well as property products that invest in, for instance, developments in the Baltic and Eastern European regions.

Each of these may be a perfectly sound investment in the context in which they are sold, but will generally be much better suited to the satellite element of a higher-risk portfolio.

“The best way to start diversifying your portfolio, blending together the myriad of options in a way which is most suitable, is to speak to us.”

In this way, they can aid diversification while featuring exposure to some exotic areas of the investment world. However, bought alone or as part of the core portfolio, they would usually be considered too high a risk.

The best way to start diversifying your portfolio, blending together the myriad of options in a way which is most suitable, is to speak to us.

Not only can we offer vast experience of the investment market but we can also advise on the most suitable structures and products for your investments to help match your own circumstances.

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