Diversification

What is it and how can it benefit you?

Part of our '*Simply Talking*' series

Purposeful • Money

A diversified portfolio is a core principle of investing

Simply talking, diversification is not putting 'all your eggs in one basket'.

While that sentiment captures the essence of the subject, it provides little guidance on the practical implications of the role diversification plays in an investors portfolio and offers no insight into how a diversified portfolio is actually created.

In this booklet we will provide you with an overview of diversification and some insight into how it works in practical terms.

So what is diversification?

The concept is to create a portfolio that includes multiple investments in order to reduce risk.

Diversification is a risk management strategy that reduces risk by allocating investments between a range of financial instruments, categories and industries. The rationale behind this investment approach is that a portfolio constructed of different types of investments may yield higher returns and pose an overall lower risk than any one individual investment found with-in the portfolio. It must be said that the benefits may be more pronounced the longer the term a diversified investment portfolio is held.

Simply talking; diversification enables you the potential to reduce the risk of your Portfolio without sacrificing potential returns

What does this tell us?

Diversification reduces the overall level of volatility and potential risk. When investments in one asset class perform badly, other investments in the portfolio with a negative correlation to the poorly performing investments should perform relatively better, and at least partly offset losses and reduce overall volatility.

In this context there are two main categories of risk that need to be considered:

Unsystematic Risk (Specific Security Risk)
This is the risk that is associated with the decrease in value of certain investment sectors, regions or asset types in general.

Systematic risk (Market Risk)
These risks include interest rates, inflation wars and recession.

Diversification doesn't act as a guaranteed safeguard against financial losses but it's arguably the most important factor of being able to reach long-range financial goals while lessening potential risk. Diversification is the only way to generate additional returns for investors without taking on additional risk. Spreading investment risk over different markets is key to protecting your money against the negative effects of market fluctuations.

If you hold just one investment and it performs badly you could potentially lose all your money. If, on the other hand, you hold a diversified portfolio of investments it is much less likely that all of them will perform badly at the same time. The growth that you will gain on the investments that perform well will potentially offset the losses on those that do not perform so well.

The main point is that for diversification to work the funds in the portfolio should not move together. The less correlated they are the better. For example if you invested everything in Global Equities, it is fair to say that when one fund performs badly, as a result of market conditions, then to some degree the other funds in the portfolio will also be affected. Even though you have spread your money over several different funds you will still suffer when market conditions effect Global Equities as a whole. This is why many investors go one step further and diversify across different asset classes.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Q32018
Govt bonds 52.60%	EME 59.40%	REITS 31.60%	EMD 9.30%	REITS 14.90%	DM Equities 25.00%	REITS 35.10%	REITS 8.20%	HY bonds 36.30%	EME 25.80%	DM Equities 9.80%	DM Equities 6.40%
IG bonds 26.50%	HY bonds 41.90%	EME 22.90%	REITS 8.10%	HY bonds 14.30%	HY bonds 5.30%	EMD 12.10%	EMD 7.10%	Cmdty 33.30%	DM Equities 12.40%	REITS 5.60%	HY bonds 3.20%
EMD 23.30%	DM Equities 16.40%	Cmdty 20.50%	Govt bonds 7.10%	EME 13.40%	Hedge Funds 4.70%	DM Equities 12.10%	DM Equities 5.50%	EME 33.10%	HY bonds 0.90%	HY bonds 3.10%	EMD 3.10%
Cash 6.90%	EMD 14.10%	HY bonds 18.40%	IG bonds 5.10%	EMD 13.30%	REITS 1.30%	IG bonds 9.60%	HY bonds 2.90%	EMD 31.40%	Cash 0.40%	Hedge Funds 2.40%	REITS 1.90%
Hedge Funds 6.30%	REITS 13.50%	DM Equities 15.90%	HY bonds 3.90%	DM Equities 11.40%	Cash 0.50%	HY bonds 6.20%	Govt bonds 2.30%	REITS 30.40%	EMD -0.10%	Cmdty 1.60%	IG bonds 1.70%
HY bonds 1.20%	IG bonds 6.10%	EMD 15.60%	Cash 1.20%	IG bonds 6.30%	IG bonds -1.50%	Hedge Funds 5.60%	IG bonds 2.00%	DM Equities 29.00%	REITS -0.20%	Govt bonds 1.20%	Hedge Funds 0.80%
Cmdty -10.90%	Cmdty 5.90%	Govt bonds 9.20%	DM Equities -4.30%	Cash 1.40%	EME -4.10%	Govt bonds 5.40%	Hedge Funds 1.90%	IG bonds 24.40%	IG bonds -0.40%	IG bonds 0.90%	EME 0.30%
REITS -13.20%	Cash 2.20%	IG bonds 9.20%	Hedge Funds -8.20%	Hedge Funds -1.00%	Govt bonds -6.10%	EME 4.30%	Cash 0.70%	Hedge Funds 22.30%	Govt bonds -2.00%	Cash 0.60%	Cash 0.20%
DM Equities -17.40%	Hedge Funds 1.00%	Hedge Funds 8.50%	Cmdty -12.70%	Govt bonds -2.60%	EMD -8.30%	Cash 0.60%	EME -9.70%	Govt bonds 21.30%	Hedge Funds -3.20%	EMD 0.10%	Govt bonds -0.50%
EME -35.20%	Govt bonds -8.60%	Cash 0.90%	EME -17.60%	Cmdty -5.40%	Cmdty -11.20%	Cmdty -11.80%	Cmdty -20.30%	Cash 0.70%	Cmdty -7.10%	EME -3.90%	Cmdty -0.80%

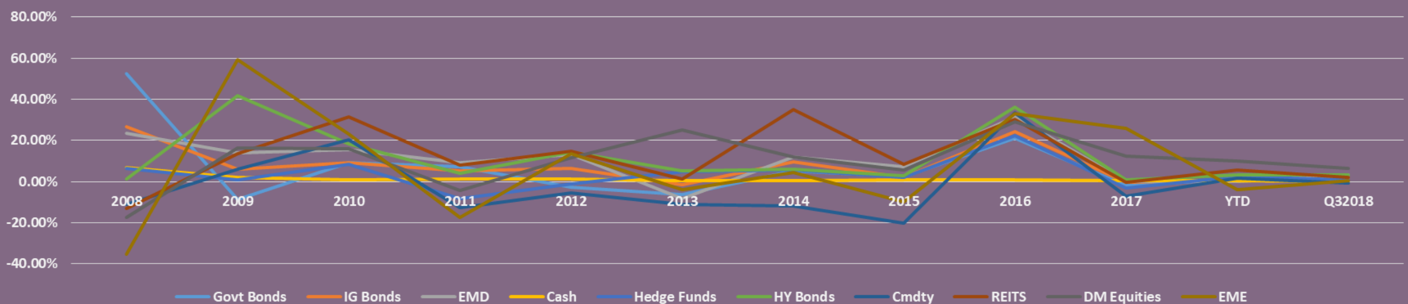
Source: Barclays, Bloomberg, FTSE, MSCI, J.P. Morgan Economic Research, Thomson Reuters Datastream, J.P. Morgan Asset Management. Annualised return covers the period from 2008 to 2017. Vol. is the standard deviation of annual returns. Govt bonds: Bloomberg Barclays Global Aggregate Government Treasuries; HY bonds: Bloomberg Barclays Global High Yield; EMD: J.P. Morgan EMBI Global; IG bonds: Bloomberg Barclays Global Aggregate – Corporates; Cmdty: Bloomberg Commodity; REITS: FTSE NAREIT All REITS; DM Equities: MSCI World; EME: MSCI EM; Hedge funds: HFRI Global Hedge Fund Index; Cash: JP Morgan Cash
United Kingdom (3M). You will find a glossary of terms on page 7 of the booklet.

Asset class performance, history of top performing asset classes

The matrix above shows how volatile some investment markets have been in the past 9 years. As an example let's look at EME (Emerging Market Economies) and Government Bonds. As can be seen, the two markets are very turbulent, rising and falling year in year out. No set asset class has ever performed consistently, and one can't predict performance either. What can be seen from this historic data is that where Government Bonds have performed well such as in 2008, EME has underperformed. The reverse has also been the case such as in 2009 where EME outperformed Government Bonds by some margin.

Bonds and Stocks often move in opposite directions. When investors expect the economy to weaken and corporate profits to drop, stock prices often fall. At the same time Central Banks may reduce interest rates to reduce borrowing and stimulate spending. This often causes Bond prices to rise. In this scenario if your Portfolio held both Bonds and Stocks it is likely that the increase in the value of Bonds would help to offset the decrease in the value of your Stocks.

Below is the same asset class performance but in graph format. Here we can see more clearly the volatile performance of each asset class over the same period.



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What is Asset allocation?

Simply talking: Asset allocation is based on the practice of diversification but takes the process one step further. It is the practice of diversifying asset classes such as UK Equities, Global Equities, Fixed Interest and Bonds. Asset allocation has been recognised as a very important part of the process of building a portfolio. In fact a number of studies have shown that the de-cision how to divide up a portfolio into several classes is more important that the process of choosing the actual stocks and funds that are owned.

Asset Allocation is the process of determining which mix of assets to hold in your portfolio. The asset allocation which works best will largely depend on the determined time horizon and ability to tolerate risk

Time horizon
The time horizon is the expected number of months or years you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable accepting a more volatile investment because the inevitable ups and downs of the market may well be smoothed out over this time period. Conversely an investor with shorter term objectives would likely accept less risk because of the shorter time horizon

Risk Tolerance
This is the ability and willingness to lose some of your investment in the shorter term in exchange for greater potential returns. A conservative or cautious investor tends to favour investments that will preserve the original capital and conversely again a more adventurous investor might be willing to lose some money in order to potentially obtain better returns in the long term .

Below is a table that identifies several asset classes alongside their associated risk profile. As can be seen each asset class has a different risk profile. Cash and Premium Bonds for example represent a lower risk to an investor whilst investments directly into commodities, in isolation, may represent a higher level.

Asset class	Risk profile
Cash – Savings, current accounts, savings and premium bonds, Cash ISAs etc.	Risks associated are low however money's value falls over time if inflation is greater than the interest rates paid.
Fixed interest securities/bonds – gilts, local authority bonds, corporate bonds	If held to maturity, returns are relatively low but predictable. Volatility can arise in traded prices. Again, money's value can fall over time if inflation is greater than the interest rate paid on the bond.
Shares – Shares held directly/through investment pool e.g. unit trust or OEIC	Investing in one single company is very high risk . Investment through a fund decreases risk but levels of risk will depend on the type of shares in the fund.
Property – commercial or residential property, investments in property funds or companies	Volatility may be higher than that of bonds.
Commodities (hard and soft) – e.g. gold, coffee, oil	Very unpredictable risk profile that depends on niche market conditions and quality. Usually trade on future markets so even riskier.

Different types of Asset Allocation strategies

Strategic Asset Allocation

The primary goal here is to create an asset mix that provides the balance between expected risk and return for the long term investment horizon. In this instance the asset allocation does not change relative to changes in the market or economic conditions

Dynamic Asset Allocation

This is similar to Strategic asset allocation in that the approach is to largely retain the original asset mix, however dynamic asset allocation portfolios will adjust their approach over time relative to changes in the economic environment

Tactical asset allocation

This is a strategy where a more active approach is taken to try and position a portfolio in those assets, sectors, or stocks that show the most potential for perceived gains. While an original asset mix is formulated in the same manner as Strategic or Dynamic asset allocation, tactical strategies are more able to freely move entirely in and out of their core asset classes.

The connection between Diversification and Asset Allocation

Diversification is the strategy that involves spreading your money among various investments in the hope that if one investment loses money the remaining investments will more than make up for those losses.

Asset Allocation as discussed is the strategy involving dividing an investment portfolio among different asset categories such as stocks, Bonds and cash.

A truly diversified portfolio should be diversified at two levels: between asset categories and within the asset categories. In addition to allocating the investments among stocks, Bonds, Cash etc. it is necessary to spread out the investments within each of those categories by investing in different industries and geographical sectors. An example would be to invest in Equities as the asset class and then to further diversify by investing in Equities in different Geographical regions and industries.

Summary of the benefits of Diversification?

Ultimately the main benefit of diversification is that it helps reduce the overall risk of your portfolio, if a single investment is not performing very well it's performance should be balanced out by other investments which are doing better at that particular time.

Key benefits of diversification:

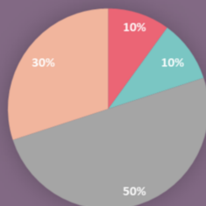
1. Reduce overall portfolio risk – if there is one investment in the portfolio performing poorly over a certain period of time, other investments may be performing better during that same period. Potential losses can be reduced by not concentrating all of your capital in one type of investment.

2. Making returns – sometimes investments don't perform as you would expect them to, when you diversify you are not just relying on one source of income.

3. Preserving capital – not everyone is at the stage in their life where they want to make considerable returns and if pre serving your capital is your end goal, diversifying your investments can help achieve that.

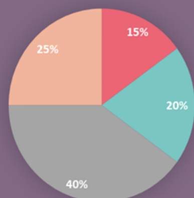
The five pie-charts below show some very simple examples of diversified portfolios with their asset allocation dependent on the type of returns someone wants to achieve, while still considering the amount of risk they are able to take. As can be seen the lower risk portfolio has half of its investment in Government bonds and Property with less exposure to equities. In contrast the more adventurous Portfolio has less exposure to Government Bonds and property and more exposure to UK and International Equities.

Lower Risk



UK Equities · International Equities · Gov't Bonds · Property

Low-Medium Risk



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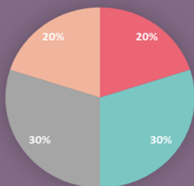
Medium Risk



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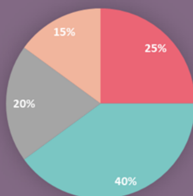
Medium-High Risk



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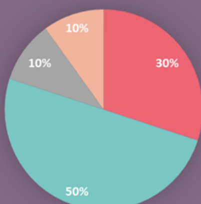
Higher Risk



UK Equities · International Equities · Gov't Bonds · Property

This above pie charts represent a simple example of how portfolios can be constructed based on the allocation of asset classes dependent on a chosen risk profile. This should not be viewed as a advice or be construed as a recommendation by Purposeful.Money.

Past performance is not a guide to future performance. The value of investments and any income from them can fall and you may get back less than you invested. If you invest in currencies other than your own, fluctuations in currency value will mean that the value of your investment will move independently of the underlying asset.

The information contained in this documentation has been taken from sources stated and is believed to be reliable and accurate, but without further investigation cannot be warranted as to
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Glossary of terms:

IG Bonds	Investment Grade Bonds
Gov't Bonds	Government Bonds
EMD	Emerging Market Debt
HY Bonds	High Yield Bonds
Cmdty	Commodities
REITS	Real Estate Investment Trusts
DM Equities	Developed Market Equities
EME	Emerging Market Economies

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