

Don't put all your eggs in one basket

Holding a blend of assets to help you navigate the volatility of markets

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'.

In the most general sense, it can be summed up with this phrase: 'Don't put all of your eggs in one basket'.

While that sentiment certainly captures the essence of the issue, it provides little guidance on the practical implications of the role diversification plays in a portfolio.

MINIMISING RISK

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 an international stock market volatility.

FURTHER DIVERSIFICATION

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.

Similarly, the risk and return profiles of shares in younger companies in growth sectors like technology, for example, contrast with those of established, dividend-paying companies.

PORTFOLIO INSULATION

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

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.

INDIVIDUAL INVESTORS

Achieving effective diversification across and within asset classes, regions and currencies can be difficult, however, and typically beyond the means of individual investors. For this reason, some people choose to invest in professionally managed funds that package up several assets, rather than building their own portfolio of individual investments.

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 FUND

One alternative is to invest in a multi-asset fund, which will 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.

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. ■

TIME TO TAKE STOCK OF YOUR PARTICULAR SITUATION?

As with all investments, investors should always check whether the strategy and underlying investments of any fund, or combination of funds, match their own attitude towards risk and return. Whatever phase of investment you are in, from capital accumulation to drawing upon your savings, there is always a valuable role for effective diversification. If you would like to take stock of your particular situation, please contact us.

