GUIDE TO DIVERSIFICATION

This guide is designed to help start you on the road to building an investment portfolio. With a little groundwork, a balanced, well-diversified portfolio ought to be able to weather the short-term storms of stock and property market fluctuations. It should smooth out the various peaks and troughs and help you meet your financial objectives over the longer term, without causing too many shocks along the way.

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 buying a range of different investments, even when the area they specialise in is quite small. A smaller companies fund manager, for example, with perhaps only 400 potential investments from which to choose, would suggest their hand-picked selection of 70 holdings offers diversification.

At the same time, it is my job as your financial adviser to help you diversify your portfolio by guiding you through the range of different assets, allocating your portfolio across the different options and, ultimately, helping you meet your objectives while staying within a level of risk that is acceptable to you.

When looking to invest, it is important to acknowledge that, no matter what the type of asset is, there will be risks involved. These risks are made up of two principal aspects: market risk (the impact of economic factors, say, or government changes) and investment risk (the uncertainty and volatility of returns).

Diversification can help to reduce both of these. Market risk cannot be eliminated but it can be reduced by spreading a portfolio over a range of different asset 'classes' that should behave differently in different market environments. By broadening a portfolio's exposure across a range of asset classes, you raise your chances that, at any one time, some assets will be rising while others may be falling – and the two movements should, to an extent, offset each other.

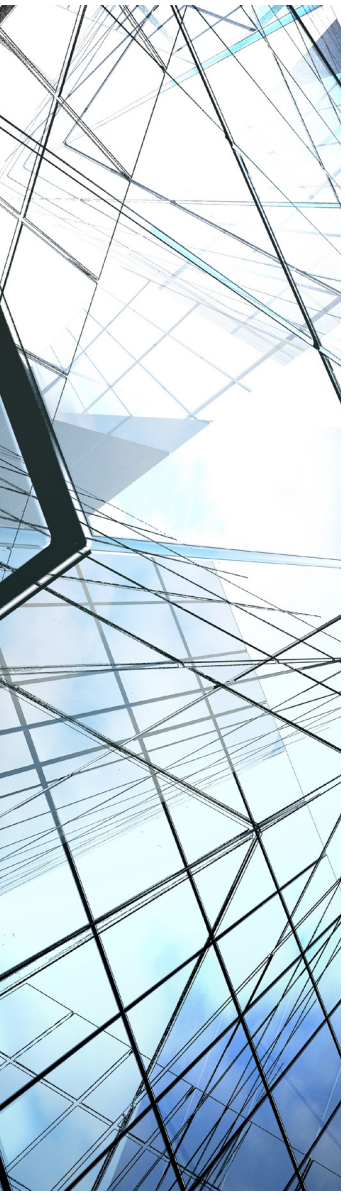
The same holds true for investment risk. While, for example, all shares are similarly exposed to investor sentiment towards the stockmarket on which they are listed, the investment specific risk will vary from company to company. This means the share prices of each company will not move in the same direction, by the same amount and at the same time. Each share plots its own path, resulting in a smoothing of returns.

Investing across different asset classes sounds like a good move but you should also be aware of the other side of the coin. By diversifying your portfolio, you will also lower the level of return you would have received if you were fortunate enough to be invested only in the best-performing asset class. The skill comes in balancing your asset allocation so the relative payoff matches your own attitude to risk and reward.

This might lead you to ask how diversified your portfolio should be and the answer will depend greatly on your attitude to risk. Given the lessons of history, we can with some confidence assume nobody can accurately predict the performance of markets to the degree they will know exactly where to be invested at any point in time.

If this were possible, we would of course all be millionaires. Therefore, in effect, we use diversification to hedge our bets. The extent to which we need to diversify depends on how much volatility we feel able deal with – put simply, how much we tend to worry or panic when the value of our portfolio starts to fall.

SPREAD YOUR EGGS ACROSS MANY BASKETS



Any portfolio can be diversified. Do remember, however, when you diversify your portfolio, risk is not the only thing you will reduce. You will also lower the level of return you would have received if you had been fully invested in just the best asset class. The skill comes in balancing your asset allocation so the relative payoff matches your individual attitude to risk and reward.

So that is the theory. In practice, once you know what risk you can deal with, the effectiveness of your diversification strategy will depend on the degree of 'correlation' between various elements in a portfolio – that is to say, the extent to which different investments move in relation to each other – and combining them appropriately so the overall movement is in line with your expectations.

Government bonds, for example, are perceived as being a safer haven when markets are rough and equities are volatile. Property, on the other hand, has tended to protect against inflation over the long term, while also not moving in line with equities. Then there is cash, which depends entirely on interest rates for the level of income generated. To a greater or lesser extent, each asset class responds differently to external influences such as interest rates and inflation.

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DIVERSIFY WITHIN ASSET CLASSES

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 both types of company are listed on the stockmarket, they are both exposed to factors that affect the overall equity market, such as the impact of a government's monetary policy, or general investor sentiment.

DIVERSIFY BY GEOGRAPHY

Geography also allows some of the impact of stockmarket movements to be dissipated, as your portfolio is not only exposed 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 performs badly, for example, it does not necessarily mean European stockmarkets will have fallen. And within Europe, there is the possibility of further geographical diversification, as the performance of each underlying European stockmarket will not necessarily be aligned with that of its peers.

Even so, all equities are capable of being affected by global influences and particularly when investor sentiment is involved – just consider the boom in telecom, media and technology stocks in the late 1990s and their subsequent collapse in 2000. The effects were global – although markets such as the US, which had greater exposure to these sectors, were more heavily affected, almost all countries suffered from the somewhat depressed equity environment during the bear market that prevailed through to early 2003.

DIVERSIFICATION WITHIN BONDS AND PROPERTY

The same sort of thinking can go for fixed interest investments and property. Government bonds, for example – and particularly those of more highly-rated countries such as the US or the UK – do not tend to behave in the same fashion as the

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so-called 'sub-investment-grade' corporate bonds that are issued by less financially secure companies. Within property, meanwhile, even commercial and residential property are not always correlated in the returns they offer.

MAKING YOUR DECISIONS

Most investors should in general start by making a detailed assessment of their attitude to risk. If you could not live with the fluctuations of the stockmarket and would be very worried by the sight of prices going down, then you are a lower-risk investor and your portfolio should be biased towards correspondingly lower-risk assets, such as cash and perhaps some fixed interest.

If on the other hand you are comfortable with some volatility and are investing for the longer term – at least five years, say – you might decide to include a small element of equity exposure. Then again, 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 COLLECTIVE INVESTMENTS

Collective investment funds, such as open-ended investment companies and investment trusts, are inherently diversified to some degree as they hold a number of different investments, generally in a particular market, industry sector or asset class. You could, to pick just a handful of examples, choose an emerging market equity, global technology, government fixed-interest, UK corporate bond or North American smaller companies fund.

As collective funds tend to hold 50 or more stocks, they automatically offer more diversity than just one or two stocks from these markets. By selecting funds, you hand over the job of stock diversification to expert fund managers, leaving you and your adviser to concentrate on the other main decision 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 decision process by targeting the broader portfolios of global equity or managed funds. Within these, the fund manager will diversify not only by type of company and level of exposure, but also by geography – and these portfolios usually involve some element of asset allocation as well.

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

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BRINGING IT ALL TOGETHER

When considering a portfolio's proportions, many investors pursue simple strategies such as, for example, a 'core/satellite' approach. Typically, the 'core' portion would make up the larger part of your portfolio since it should be relatively less volatile and provide a solid base on which to build. The satellite investments would then add 'spice' to your portfolio by taking smaller positions in higher-risk regions, asset classes or industry sectors.

A lower or medium-risk investor might concentrate their core portfolio in cash, bond and property funds, or perhaps in an equity fund linked to larger, more highly regulated stockmarkets such as the US or the UK. For its part, the satellite element might provide small degrees of exposure to areas such as high-yield bonds, emerging markets or specific industry sectors.

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Nowadays there are many more esoteric investment choices than ever before to capture the attention of potential investors - but they can also create unpalatable risks if bought alone.

These products might focus on areas such as resources, gold, specific emerging markets like Brazil, Russia, India or China or overseas property. Each of these may be a perfectly sound investment in the context in which they are sold, but they will generally be much better suited to the satellite element of a higher-risk portfolio. In this way, they can assist diversification while providing exposure to a relatively exotic area of the investment world. However, when bought alone or as part of the core portfolio, they would usually be considered too risky.

The best way to start diversifying your portfolio and to blend together the myriad options in a way that best suits your personal circumstances is to speak to a professional adviser. Not only are they able to offer vast experience of the investment market but they can also advise on the most suitable structures and products for your investments to help match your individual needs.

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