Guide to diversification

Given the recent market volatility, potential investors would be forgiven for thinking the best place for their money would be under their bed. While this has the obvious plus point that, barring a burglary, you will get your money back when you need it; it is likely to leave you poorer over the long-term.

Why invest?

FIRST AND MOST IMPORTANTLY, CASH DOES NOT PROTECT AGAINST INFLATION. DESPITE A RELATIVELY BENIGN INFLATIONARY ENVIRONMENT, A POUND STILL BUYS YOU A LOT LESS NOW THAN IT DID TWENTY YEARS AGO. SECONDLY, IF YOU ARE INVESTING FOR THE LONG TERM, TAKING MORE RISK COULD ACTUALLY BRING YOU GREATER RETURNS. IN FACT, EVEN IF YOU PUT YOUR MONEY IN A DECENT DEPOSIT ACCOUNT, YOU ARE STILL LESS LIKELY TO REACH YOUR LONG TERM INVESTMENT GOALS THAN IF YOU INVEST IN EQUITIES AND/OR BONDS.

In theory, this is all very well but equities, bonds and the income that they can earn you may go down in value as well as up. How do you go about ensuring you get the best return you can whilst also ensuring you don't lose the lot? The answer is diversification – and this Guide provides an introduction to the theory which can help you make the most of that opportunity.

What is diversification?

DIVERSIFICATION IS DEFINED AS THE SPREADING OF YOUR PORTFOLIO ACROSS DIFFERENT ASSET CLASSES, INCLUDING EQUITIES, BONDS, PROPERTY, ALTERNATIVES AND CASH. THE MAIN OBJECTIVE IS TO REDUCE THE RISK IN YOUR PORTFOLIO COMPARED WITH THAT OF INVESTING IN JUST ONE.

In theory, the fact that your investment is spread across different types of asset means that when one asset is underperforming, the positive performance of another asset will help to compensate for it. In this way, your portfolio will be able to provide positive returns – or smaller negative returns – than if it were all invested in the single underperformer.

The long term nature of portfolio planning means that all asset classes are likely to have their ups and downs from time to time. Diversification means you don't have to get wrapped up in worrying about which one you should be in – or out of – at any particular time.

Building a portfolio - the process in summary

1. Consider the investment amount
2. Evaluate the term of the investment
3. Assess your attititude to risk
4. Account for your personal circumstances
5. Allocate proportions to different asset classes
6. Select underlying funds, stocks and shares
7. Review position every 3-5 years

Introducing the asset classes

THERE ARE FIVE MAIN ASSET CLASSES: CASH, BONDS, PROPERTY, EQUITIES AND ALTERNATIVES.

Cash

Cash provides security of capital and an income which varies with interest rates. It is therefore a good idea to hold a decent amount of money in cash for your short-term needs. However, holding large sums in cash over the long term may actually prove to be risky, simply because the real value of your money – ie: its ability to buy a given basket of goods – can reduce over time.

For the cautious amongst us, there are ways you can manage your cash better to reduce this risk. First, shop around and ensure you are getting the best rate on your savings. Note that National Savings & Investments can offer inflation-linked certificates, albeit at a lower initial rate of interest. Money market funds might also offer higher rates of interest (and therefore greater potential for inflation protection) than a normal deposit account.

Bonds

Bonds are generally accepted as the next step up from cash in terms of risk. They are designed to provide investors with a fixed level of income (interest) and then full return of capital on a pre-agreed future maturity date. Consequently, during the life of a bond, if interest rates go up, an existing bond becomes less attractive and its capital value on paper will fall. Conversely, if interest rates go down, an existing bond paying higher interest will become more attractive and its capital value would therefore go up.

Despite their accepted position towards the lower end of the risk scale, the asset class contains many different types of bond, offering quite different levels of risk and potential reward:

a. Government bonds

As the name suggests, these are bonds issued by governments. In the UK, these are known as gilts and in the US, as treasuries or T-bonds. Government bonds are loans issued to fund public spending or investment. In return for lending money, the investor receives their pre-agreed rate of interest and is repaid their capital on the pre-fixed maturity date, perhaps 15+ years in the future. Gilts are considered amongst the lowest risk of all bonds because the UK Government is considered a highly credit worthy borrower who has never defaulted on interest payments to investors.

However, not all government bonds are the same. Higher risk governments also issue bonds and there have been notable disasters. The most recent was Argentina, where the Government defaulted on its obligations during the economic crisis of 1999-2002. Russia has done the same and emerging market countries are also considered to be outside the remit of any investor seeking stability and long term reassurance.

b. Corporate bonds

Corporate bonds are loans issued by companies, usually for future developments or investment (take-over) opportunities. Like governments, companies pay investors a pre-agreed rate of interest over the life of the bond and then pay back the original capital investment in full at maturity.

The amount of interest paid by a company will be based on the current level of interest rates and the risk of the company going bust. Different companies will have differing levels of existing borrowing, different prospects and different credit histories, each of which affects the way investors assess the risk. The higher that overall risk, the more the company will have to pay to attract investors.

To help less informed investors make decisions, most bonds are rated by independent agencies such as Standard & Poor's or Moody's. Generally, bonds from a highly credit worthy company with a good history will win an A++ or AAA rating, with the grading then scaling down alphabetically through A, BBB, B, CCC and below.

As an overview, any company or bond rated AAA, AA, A or BBB is classified as 'investment grade'. Those rated BB and below are considered 'high yield' because their risk levels mean higher interest payments are needed to attract investors. At the bottom of the scale, CCC and below, these bonds should be avoided by all but the most adventurous and experienced investors. They can carry a default risk in excess of 50% and are sometimes referred to as 'junk bonds'.

Property

Property is generally seen as the next risk level up on the scale. For many investors, the exposure provided by their own property might be considered enough. However, for those looking to extend their exposure, or who want a medium risk investment opportunity which might also provide a decent income, property offers its own benefits. There are two types – commercial and residential – and they behave in slightly different ways.

Commercial property is property used by businesses and is split into three main types - retail, industrial and offices. It offers a consistent, long-term income stream, based on long-term rental/lease agreements, with the possibility of some capital growth depending on demand. Individual properties are high value investments with long lead times and therefore most individual investors access this sector via mutual funds.

Residential property has a lower ticket value and slightly shorter lead times (although still a matter of weeks). Buy-to-let provides rental based income but leases are shorter and capital values are reliant on individual tastes – which can impact values widely, even within the same street.

Whichever option you go for, property must be considered as a long term investment and future returns should not be expected to be as high as they have been in recent years. The commercial sector in particular is very specialist and it is therefore recommended that advice is sought from an expert before any decision is made.

Equities

Equities are probably the best known assets, even if they are not the most widely understood. When you buy an equity, you buy a small share in a company and the value of that share will then become reliant both on the performance of the company concerned and on sentiment within the market as a whole.

Equities are considered high risk because their prices are volatile, varying constantly as investor sentiment shifts. Even when the performance of a company individually might be good, if the outlook for the economy is negative, the share price could fall as wider pessimism stops investors from buying.

However, over the long-term, equities have consistently provided higher returns than the other asset classes. According to Barclays Capital[1], an investor who put £100 into the stock market in 1899 and reinvested the income they earned would now be worth - in today's terms, ie: after all adjustments for inflation - £25,000. If that same £100 had been placed in gilts, it would be worth just £323, or if it had been kept in cash, it would have swelled to just £286.

This is of course, based on an average investment across the stock market where corporate profits tend to outperform inflation over the long term. Short term, however, there will be some years when this is the case and others when they miss targets, the latter of which will cause prices to fall. In addition, even while the overall market does well, there will be individual companies which do badly. There are also sub sectors which carry a greater risk, such as smaller companies or those in emerging markets. Equities should not be considered unless you are comfortable with what these ups and downs might mean for your investment over shorter periods.

[1]Barclays Capital Equity Gilt study 2007

Alternative asset classes

One final way to improve the investment mix of your portfolio is to include alternative asset classes. However, these are only suggested for the most sophisticated of investors as they also, individually, carry a significantly high – and sometimes a difficult to understand – level of risk. Any alternative asset class should only make up a relatively small part of your portfolio.

Alternative assets might include hedge funds, private equity, wine, art, classic cars and antiques. All are very specialist areas, distinct from each other. Even within the single term 'hedge fund' you will find an enormous range of different investing strategies from hundreds of different funds, some of which may be based in unregulated, offshore environments with no transparency and little come back if things go wrong.

Building your portfolio

NOW YOU KNOW THE ASSETS, YOU NEED TO WORK OUT HOW THEY WILL FIT TOGETHER TO BEST ACHIEVE YOUR GOALS.

Here the process becomes quite personal as the exact mix will depend on your age, the term of your investment, your goals and your attitude to risk.

If you are investing for the long-term, perhaps for a pension, then you should probably hold more of your portfolio in high-growth assets such as equities. You can then shift progressively into lower risk assets such as bonds or cash as you draw nearer retirement, so a sudden downturn in the equity market does not dent your pension at the last minute.

In practical terms, the premise of diversification is simple: If you have one share and the company goes bust, you lose all your money; If you have two shares and one goes bust, you still have half your money. If you have twenty shares and one goes bust, you still have 95% of your money. For this reason, collective investment funds are a useful tool as money is pooled with that of other investors and managed by a professional fund manager. These can provide access to the fortunes of perhaps 50 or even 100 shares for a relatively small sum.

Achieving diversification

CORE AND SATELLITE IS AN EASY TO UNDERSTAND APPROACH WHICH WILL CREATE A DIVERSIFIED PORTFOLIO.

Basically, this means building a safer, long-term investment as a 'core' and then adding on racier investments around the edge. The riskier 'satellite' investments can be shifted around more actively as market conditions change.

However, while this works to reduce an investors' vulnerability to individual holdings, there are certain risks, particularly in the equity market, which this strategy won't address. In the last bear market, sophisticated investors didn't lose as much money as their less skillful rivals, but they still lost money. The only way to shore up the performance of a portfolio in a declining equity market is to ensure you also hold other, uncorrelated assets.

It used to be that investors could diversify UK equities by simply investing in foreign markets. But global markets increasingly move in line with each other, often following the lead of the US. Now investors have to look further afield. Returns from government bonds and investment grade corporate bonds are only lightly correlated with equity markets. Their prices will tend to move according to the interest rate cycle and, in the case of corporate bonds, investors perception of the likelihood of default. This means the inclusion of investment grade corporate bonds and government bonds in a portfolio can help lower the risks and smooth out the returns of an otherwise purely equity portfolio.

Clearly there have been times when both equity and bond markets have fallen at the same time. This is when property, cash and alternative asset classes comes into their own. These can generate – or simply consolidate returns when the rest of your portfolio is suffering.

Of course, there is also danger in too much diversification as you could diversify away all your excess return. A balanced portfolio, appropriate for your age, expectations and attitude to risk, is the ideal way to begin investing.

Further information

This guide can only ever act as an introduction to the complexities of diversification and portfolio building. However, if it has raised your interest and you would like some help to look at your own investment goals, we can help you review your own situation in detail. Please give us a call on the number enclosed.

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