Broad diversification reduces risk

Reducing the risk in your investment strategy

An effective way of reducing risk in an investment portfolio is to introduce diversification. No one type of security, asset class, investment strategy or investment manager will necessarily provide the best performance over all time periods.

Investing in a range of options could reduce the risk of an investment portfolio suffering large drops in performance, since one asset class or manager may perform well to counter poor performance in another.

Outlined below are some ways that diversification may be used to reduce risk in an investment strategy:

1. Diversification across asset classes

Sometimes a downturn in one asset class may coincide with a rise in another asset class. Should a particular section perform badly, holding assets in other sectors may reduce the effects of the under-performing sector.

The major asset classes – cash, fixed interest, property and shares each have a level of risk and return specific to the type of investments they represent.

The four major asset classes

An asset class is simply an investment category. Cash, fixed interest, property and shares are the names given to each of the major asset classes. Each asset class differs in the level of risk and return that it can provide.

Cash

Cash is the name given to short-term debt securities (tradeable financial assets) which are issued, guaranteed or supported by state or Federal governments, banks or large companies. Examples are term deposits, cash management trusts, bank bills and other cash managed funds. Generally, these assets remain stable in price and return a modest amount of interest.

Fixed interest

Consists of securities in which income remains constant and does not fluctuate. This includes bonds, annuities and preference shares. Any debt security which has a fixed flow of income is known as a fixed interest security.

Property

Property may mean direct investment in buildings, shopping centres and industrial sites or indirect investment in listed property trusts. Listed property provides both income (mainly from rent) and capital growth through increases in the market value of the asset.

Generally property assets can have moderate to high fluctuations in their value. These fluctuations are usually less than shares over the long term but more than fixed interest and cash investments. Historically, over the long term property assets have provided higher returns than fixed interest.

Shares

Shares are listed on a stock exchange. When you invest in shares you become a part owner of the company you are investing in and if the company makes a profit, it generally pays some of its earnings to shareholders in the form of dividends.

Historically, shares have produced the best returns over time, particularly over the long term. They have also displayed the highest level of volatility of returns in terms of risk.

2. Diversification within asset classes

It may be valuable to diversify assets within a broad asset class. For example, within the broad category of 'debt' or 'fixed interest' investments, a portfolio may invest in government bonds, semi-government bonds, international bonds and inflation-linked bonds. Many of these assets also react differently to economic conditions and may provide a buffer should one category suffer a downturn in investment performance.

3. Diversification across investment styles

The performance of various investment managers will differ according to the economic environment. Investing with managers of different styles is recognition that no one investment style is likely to produce good returns at all times. Rarely, will a value manager or a growth manager produce similar investment returns over a short period of time. This is due to the fact that their 'investment styles' differ and their performance is underpinned by economic circumstances.

The overall effect of diversification is that you may moderate the volatility in your investment portfolio and 'smooth out' investment returns over time.

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