What Is Diversification?

Virtually every investment has some type of risk associated with it. The stock market rises and falls. An increase in interest rates can cause a decline in the bond market. No matter what you decide to invest in, risk is something you must consider.

Diversification

The most widely recognised method for managing portfolio risk is through diversification of investments and investment management. In order to minimise the volatility and risk of your investment portfolio, it is prudent to ensure that it is sufficiently diversified against over exposure to a single asset, asset sector, geographical region or investment manager. This is because no one asset, asset class, geographical region or investment manager provides the best performance over all time periods. A range of investments should reduce the risk of the portfolio experiencing drops in performance across the board simultaneously, as one asset class or manager may perform well to counter the poor performance of another.

Diversification Across Asset Sectors

Historically, no single asset class has consistently outperformed all others every year and hence by investing across the four main asset sectors, shares, property, bonds and cash, investors may be able to reduce the volatility of their portfolio return. If any sector is particularly volatile or performing poorly, other sectors may compensate and vice versa.

A well diversified investment portfolio would include exposure to the four major sectors. However diversification can be further achieved within each asset sector, for instance the Australian sharemarket has many types of sectors including banking, resources, manufacturing, technology and media. Spreading of investment within this sector can reduce the volatility of returns as each industry's performance will differ depending upon prevailing market conditions.

Diversification Across Investment Management Styles

Different investment management styles tend to excel at different times under different economic and market conditions. Diversification of investment managers can lower the risk profile of your portfolio by providing exposure to different management styles. For instance, one manager may have a buy and hold approach while another may adopt an aggressive trading strategy. Managers may have preferences for shares with certain characteristics, for example targeting those that produce franked dividends or that are likely to produce high capital growth.

Each of these management styles can have an impact on your portfolio return and

your risk profile. By combining a range of investment managers with complementary investment styles you will be able to reduce the bias to any one style in each asset sector and can reduce the impact of any one investment under-performing for a period of time in comparison to other investments.

Diversification Across Markets and Regions

It is also valuable to spread your exposure within each asset sector across a wide range of countries and currencies. This global approach ensures that your investment is not narrowly concentrated in a particular region or industry, and helps to reduce the impact of a regional or industry downturn.

There is no right or wrong mix of investments or management styles for a given portfolio. The mix depends entirely on your risk profile and your individual desires and objectives for the portfolio. Some investors may be comfortable with investing entirely in the sharemarket while others may seek only limited sharemarket exposure.

Before accepting and implementing any investment recommendation you should be comfortable that the benefits of diversification have been considered and that, where appropriate, a balanced, well-diversified portfolio is structured to meet your needs.

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