Skandia

principles of investment

produced in association with

the importance of diversification

This 'principles of investment' factsheet looks at the importance of spreading the risks associated with investing when creating a balanced investment portfolio. Topics covered include:

- reduce the risk: diversify
- asset allocation
- stock specific risk
- market capitalisation
- sector exposure
- geographic location
- investment style

This factsheet will give you a basic understanding of the importance of diversifying an investment portfolio. Your financial adviser will be able to recommend the most effective way to diversify investments for your own specific investment needs.

reduce the risk: diversify

Risk is a necessary and constant feature of investing in equities, and a key consideration for any investor; stocks fall, economic conditions fluctuate, companies can occasionally go bankrupt.

There are many different asset classes in which you can choose to invest, each possessing different risk characteristics. Whilst the risks attributable to each individual asset class cannot be avoided, when part of a portfolio and managed collectively, they can be diluted **- the key is not to put all your eggs in one basket.**

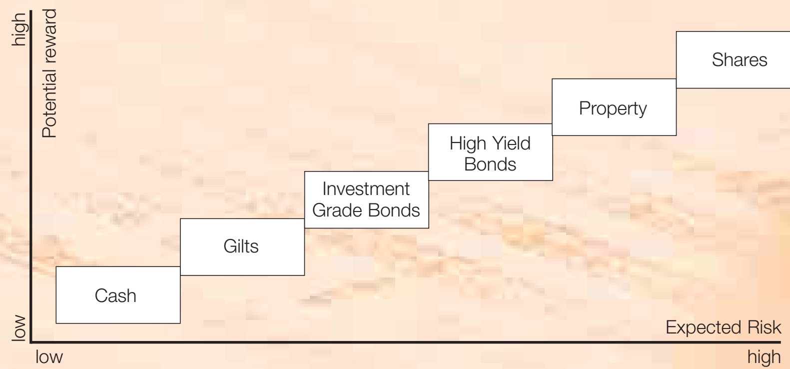
Here lie the fundamentals of **diversification -** spreading an investment across a wide range of asset classes and sectors, thereby avoiding the risk that your portfolio will be overly reliant upon the performance of one particular asset.

Before we discuss the basic premise of diversification in more detail, it's important to note that building a diversified portfolio takes time and investment knowledge. Keeping track of a number of different shares or bonds at once can be a daunting task. An easier solution can be taking advantage of collective investment schemes - your financial adviser will be able to recommend the right kinds of collective investments for your own investment needs and risk profile.

asset allocation

The single best way to diversify your investments is to spread the risk across several different asset types. The principle choice of assets is between equities, bonds, cash and property. These classes can then be further divided. For example, gilts, corporate and high yield bonds fall under the 'bond umbrella'.

Each of these classes have different 'risk/return' characteristics, as illustrated in the graph, right.



The aim is to select asset classes that behave in different ways; the theory being that when one class is underperforming, the other is outperforming. For example, some assets, such as bonds and property are particularly useful in creating a balanced portfolio of investments; they behave very differently to equities, often offering lower but more consistent returns. This provides a 'safety net' if there were to be a fall in the stock market.

By spreading investment between different asset types, such as bonds and equities, the investor diversifies away many of the risks associated with the reliance upon one particular asset - this is key to the concept of diversification.

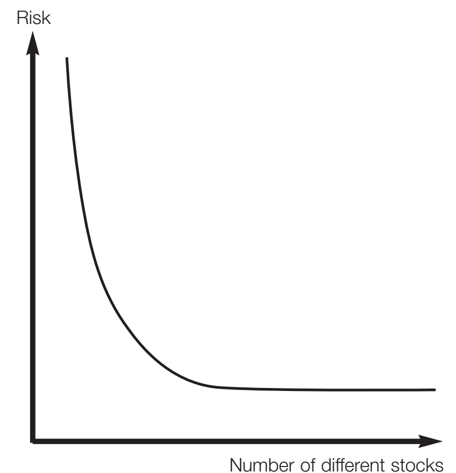
stock specific risk

Avoiding the risks associated with the reliance upon one particular asset can be taken further in the necessity to avoid share specific risk.

When investing in a share, you are completely reliant upon the fortunes of one company. If the company fails to perform, the value of its share will decrease, along with the value of your investment. By investing in more than one company, the likelihood that all will fail to perform, resulting in a collection of plummeting share prices, is significantly reduced. Consequently there is a clear relationship between the risk to your investment and the number of different shares in a portfolio.

By investing in as little as 20 different stocks, the majority of share specific risk can be diversified away, as illustrated.

The well documented demise of what was once one of America's biggest companies, Enron, has illustrated the danger associated with investing in seemingly safe, large, multinational organisations. Whilst the impact of the demise would have been catastrophic to an individual with their life savings in the company, an investor holding Enron as part of a well diversified portfolio would have seen the effect considerably diluted.



market capitalisation

Investors hold shares in companies, which can be categorised by their size. Smaller, younger companies are less established than larger, older organisations, and are therefore generally considered to be riskier.

As well as spreading your investment across a number of individual shares, it is perhaps wise to ensure that all of your different shares do not represent a stake in companies very similar in size as the risks associated with, for example, smaller companies will span the breadth of your total portfolio. By diversifying across medium and larger sized organisations, you are reducing your dependence upon the performance of one particular genre of company.

sector exposure

Depending on what they sell, produce, or what service they provide, companies can be classified by 'sector'. For example BT resides in the 'telecommunications' sector, BP in the 'Oil and Gas' sector.

Just as it is important to spread your investment across different companies, it is also wise to select companies from different sectors.

For many reasons, companies within varying sectors perform in very different ways. One way of determining the behaviour of a sector is to look at their position in 'the business cycle', as shown to the right. This highlights the theoretical recovery or recession stages in economic activity, which can be divided into four phases.

As you can see, the growth expectations of sectors are highest as they move into the 'cyclical growth' phase.

However, stocks within these sectors are considered to be more volatile. The defensive phase, containing sectors such as 'Food producers and processors', will generally be less volatile, due to the fact that, irrespective of the state of the economy, we all need to eat!

By diversifying across sectors an investor can access stocks with high growth expectations, without over-exposing their portfolio as a whole to risk. Holding stocks in the defensive phase provides the portfolio with stability should the cyclical stocks drop rapidly in value. Picking the right balance of these depends upon your own risk profile - your financial adviser will be able to assist you in creating the right balance for your investment objectives.

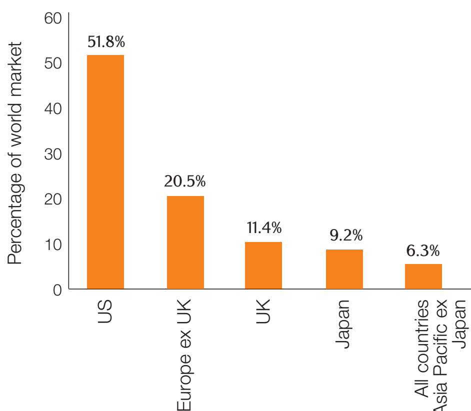
geographical location

Diversifying your investment is not only about assets and sectors; it can be achieved geographically too.

It might feel better to invest most of your portfolio in your own home market - but is it the most sensible option? According to the MSCI World Index, the United States makes up more than half the world market. The UK accounts for only 11% and Europe (excluding the UK) 20.5%, as shown below, left.

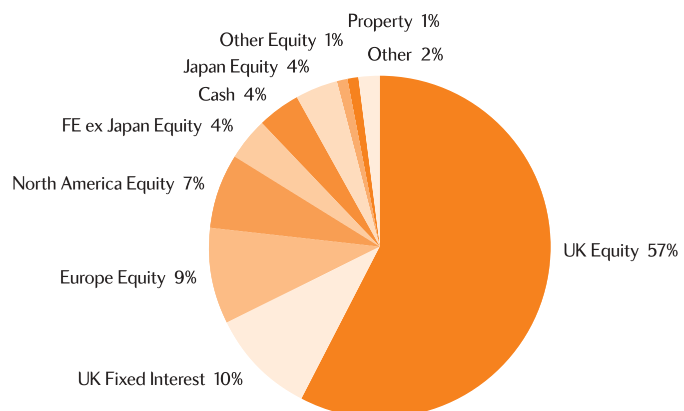
Based on statistics it seems that UK investors are prepared to take a very high risk, with more than 50% investing solely in UK listed equities. In fact, as shown in the pie chart below, only 9% invest in European equities and even less, 7%, invest into North American financial markets.*

it can pay to go global



Source: Fidelity Investments May 2005

a typical UK-domiciled investor



*Source: Fidelity, May 2005.

Holding the majority of investments in your home market is fine if the investor has picked the right market and the right assets, at the right time. But is that realistic? Probably not; the table below shows the best and worst performing markets and asset classes over recent years. As you see, to be able to invest in the 'winners' and avoid the 'losers' would indeed have led to powerful performance, but look how hard it is to spot these. The distribution is very wide, making this sort of strategy, in practice, extremely difficult.

harder than it looks

	US S&P 500 Composite	UK FTSE All share	Europe MSCI Europe (ex. UK)	Japan MSCI Japan	S.E. Asia MSCI Pacific	UK Bond ML UK Gilts All maturities	Intl. Bond CGBI WGBI All maturities	Cash JPM UK Cash 1M
1997	38.7	23.1	30.0	-20.5	*-28.0*	14.7	4.2	6.8
1998	27.2	13.8	32.5	4.1	*-7.3*	19.6	14.0	7.7
1999	25.0	24.2	21.6	67.0	47.8	*-1.3*	-1.2	5.7
2000	-1.9	-5.9	0.2	*-22.4*	-8.5	8.9	9.6	6.1
2001	-9.6	-13.3	-19.9	*-27.4*	-7.0	3.2	1.6	5.4
2002	*-29.6*	-22.7	-27.6	-18.7	-14.8	9.4	8.0	4.1
2003	15.7	20.9	29.2	22.4	32.2	*2.1*	3.3	3.8
2004	3.4	12.8	14.1	8.1	20.8	6.6	*2.9*	4.5

Blue = best performing *Red* = worst performing Source: Fidelity Investments May 2005

By investing in only one market an investor is ignoring the majority of companies open to investment and not taking full advantage of global diversification opportunities:

North America
8519 stocks listed

Asia Pacific ex Japan
7061 stocks listed

Europe
3736 stocks listed

Japan
3401 stocks listed

Rest of the world
2523 stocks listed

UK
1858 stocks listed

*Source: Fidelity, May 2005.

investment style

This final facet of diversification highlights the importance of ensuring an overall portfolio has exposure to varying types of investment style. Some shares are held as investors believe their value is likely to significantly grow over the long term, these are known as 'growth shares', others are held as they are regarded as being cheaper than the intrinsic worth of the companies in which they represent a stake, known as 'value shares'.

It is important to have a blend of styles to ensure that the portfolio as a whole is not overly vulnerable to the risk/return characteristics of each individual share type.

summary

The key benefit of diversification is the reduction in the reliance upon one particular asset class, stock, sector or geographical region, thus decreasing the overall risk of the portfolio.

The premise of diversification is a simple one; whilst one asset in an investment portfolio may be declining in price, another unrelated asset may be gaining; maintaining the balance required for a healthy portfolio.

In practice, it is much more difficult to create the right balance of assets, sectors, investment types and markets to suit your specific investment objectives and risk profile. However, the innate diversification qualities of collective investment schemes, combined with the 'know-how' of a financial adviser can present a sound, individually tailored diversification solution.

Your financial adviser will be able to recommend collective investment schemes to suit your individual investment objectives and risk profile.

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