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FACTSHEET

Managing volatility

Diversification is paramount in uncertain times

The outbreak of coronavirus (COVID-19) has understandably been dominating the news headlines. Market fear over the escalating global spread of coronavirus has seen a sell-off across many asset classes. This period of market stress further emphasises the importance of diversification within portfolios. Investors' objectives can rarely be met by investing in a single asset class.

Diversification means making sure your portfolio has varied investments: investing in stocks and bonds, in different industries, and in large and small companies. While 'don't put all your eggs in one basket' is a well-used adage, it is still relevant today and means: don't have all your money in one place, as you could lose it all in one go.

SMOOTHER RETURN PROFILE

By holding well-diversified assets at both a geographical and asset-class level, our portfolios experience a (relatively) smoother return profile because risk exposure is less concentrated.

Investment options span every sector of the stock, bond and property markets, but allocating your assets based on performance alone is often ill-advised because the market is a moving target. One year, a particular type of security can be a star performer, only to severely underperform the very next year.

RANGE OF ASSETS

During the early weeks of the coronavirus outbreak, the response from financial markets was somewhat muted. However, as the virus has continued to spread, markets have reacted in a more pronounced way to the impact on supply chains, tourism and global demand.

This further strengthens the case to invest across several asset classes to provide greater diversification potential. Therefore, if one asset class performs favourably, it can potentially offset another that is performing less favourably, providing more balance to your portfolio when market shifts occur. Investment returns vary significantly between different investment 'baskets', or asset classes, year-to-year.

ASSET CLASSES	MAIN ADVANTAGES	MAIN RISKS
Cash	Relatively secure	May lose value if the interest rate doesn't keep up with inflation.
Bonds	Regular income	The bond issuer is sometimes unable to repay in full.
Shares	Regular income and opportunity to grow over time	Share prices can go up and down. A fall in share price will reduce the value of your investment
Property	Stable and regular income, potential to grow over time	Property prices can fall reducing the value of your investment. Property transaction take a long time, so your money may be tied up for longer than you want it to be.

DIFFERENT LIFE STAGES

Different investors are at different stages in their lives. Younger investors may have a longer time horizon for their investing than older investors. Risk tolerance is a personal choice, but it's good to keep perspective on personal time horizons and manage risk according to when access to funds from different assets is needed. If cash is needed in the near term, it is better to sell an asset when you want to sell it rather than when you have to sell it.

Under normal market conditions, diversification is an effective way to reduce risk. If you hold just one investment and it performs badly, you could lose all of your money. If you hold a diversified portfolio with a variety of different investments, it's much less likely that all of your investments will perform badly at the same time. The profits you earn on the investments that perform well offset the losses on those that perform poorly.

MINIMISING RISK

While it cannot guarantee against losses, diversifying your portfolio effectively – holding a blend of assets to help you navigate the volatility of markets – is vital to achieving your long-term financial goals while minimising risk.

As well as investing across asset classes, you can further diversify by spreading your investments within asset classes. For instance, corporate bonds and government bonds can offer very different propositions, with the former tending to offer higher possible returns but with a higher risk of defaults, or bond repayments not being met by the issuer.

But although you can diversify within one asset class – for instance, by holding shares (or equities)

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in several companies that operate in different sectors – this will fail to insulate you from systemic risks, such as international stock market volatility.

ASSET CLASSES

There are four main types of investment, known as 'asset classes'. Each asset class has different characteristics and advantages and disadvantages for investors.

MARKET TIMING

Resist the temptation to change your portfolio in response to short-term market movement. 'Timing' the markets seldom works in practice and can make it too easy to miss out on any gains. The golden rule to investing is allowing your investments sufficient time to achieve their potential. Warren Buffett, the American investor and philanthropist, puts it very succinctly: 'Our favourite holding period is forever.'

Over the long term, investors will experience market falls, which happen periodically. Generally, the wrong thing to do when markets fall by a reasonable margin is to panic and sell out of the market – this just means you have taken the loss. It's important to remember why you're invested in the first place and make sure that rationale hasn't changed. ■

OPTIMAL BALANCE OF RISK AND RETURN

Whatever your approach to not 'putting your eggs in one basket' is, diversification can help manage your investment risk. If you would like further information or to discuss your requirements, please contact us.