FACTSHEET INVESTMENT

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INVESTMENT DIVERSIFICATION

PROTECTING YOUR MONEY FROM ADVERSE MARKET CONDITIONS

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Today's markets are as uncertain as ever. But there is one certainty – the future is coming. It may no longer be enough to simply preserve what you have today; you also have to build what you will need for tomorrow. When deciding whether to invest, it is important that any investment vehicle matches your feelings and preferences in relation to investment risk and return.

Recent market volatility has left investors feeling uncertain and many have stepped away from investing in the stock markets. But not all stocks and shares are the same. For those seeking long-term total returns, there still are some high quality companies – at attractive prices – offering the potential to grow wealth over time.

Long-range financial goals

Diversification is a term that can be summed up with this phrase: "Don't put all your eggs in one basket." Diversification is a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. It aims to maximise return by investing in different areas that would each react differently to the same event. Diversification is the most important component of reaching long-range financial goals while minimising risk.

Hence your asset allocation needs to be commensurate with your attitude to risk. Another key question to ask yourself is: 'How comfortable would I be facing a short-term loss in order to have the opportunity to make long-term gains?' If your answer is that you are not prepared to take any risk whatsoever, then investing in the stock market is not for you.

Varying trading fortunes

However, if you are going to invest, you need to be prepared to take some calculated risk in the hope of greater reward. Risk is an implicit aspect to investing, shares can fall, economic conditions can change and companies can experience varying trading fortunes.

The process of deciding what proportion of your investment portfolio should be invested in the different types of investment is called 'asset allocation'.

Asset classes

The various asset classes come with different levels of risk (volatility of returns) and thus deliver different expected returns over the medium- to long-term. But, no one asset class always performs best over an investment period. Asset classes include equities (shares), fixed-interest assets (such as bonds), property, cash and alternative assets (such as private equity).

Equities

The risks related to investing in equities can be reduced if you invest through an equity fund. A fund manager selects a range of equities so you are less reliant on the performance of any one company.

It also means that you don't have to choose the right companies to invest in yourself, but can rely on the knowledge and experience of the fund manager to choose companies which they feel will perform the best.

Most equity funds come into one of the following categories:

Growth funds - these aim to achieve long-term capital growth. The fund manager selects companies which show the best potential for increasing their share price.

Income funds - these aim to generate an attractive income for investors. The fund manager will try to select companies that pay regular dividends. Their share prices tend to be less volatile than those of other companies.

Bonds

Bonds are loans issued by companies (corporate bonds) or by governments (gilts in the UK and treasury bonds in the US) in order to raise money. In effect they are IOUs that promise to pay your money back on a specified date

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and pay a fixed rate of interest along the way.
On the whole, investing in bonds is seen as lower-risk than investing in equities. Gilts are very low-risk. It is considered unlikely that the UK Government will fail to pay back money owed to investors. But with corporate bonds there is a risk that the company may not be able to repay its loan or that it may default on its interest payments.

Cash

Cash accounts are considered the safest form of investment. Bank and building society accounts pay regular interest and give fairly easy access to your money. They're a good place for money you may need in the short-term, but over the longer term they offer lower potential for growth than equities, bonds or property.

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Additionally, your money could be eroded by the effects of inflation and tax. For example, if your account pays 5 per cent but inflation is running at 2 per cent, you are only making 3 per cent in real terms. If your savings are taxed, that return will be reduced even further.

Cash funds use the pooled savings of many investors in order to benefit from higher interest rates that are not usually available to individual investors.

Under current legislation, you can invest in a cash fund as part of your annual ISA entitlement - for the tax year 2013/2014 (6 April 2013 until 5 April 2014) you can save up to £5,760 in a Cash ISA.

Please note that unlike a deposit account, the value of the fund can go down as well as up. The value of tax savings and eligibility to invest in an ISA will depend on individual circumstances, and all tax rules may change in the future.

Property

Most people who have bought their own home will realise that property can be a good investment - house prices rose significantly in recent years, although this growth has stalled recently. Some people also chose to invest in other properties, such as buy-to-let flats and holiday homes.

Different characteristics for risk

These asset classes have different characteristics for risk. When you are young you may want to invest in assets with a higher potential for growth but greater risk, because you have the time to benefit from their long-term growth. As you get closer to retirement you may want to choose more conservative investments that are steadier in both risk and return.

There is a wide variety of different asset classes available to invest in and commensurate risks attached to each one. While these implicit risks cannot be avoided, they can be mitigated as part of the overall investment portfolio by diversifying.

If you put all of your eggs in one basket, you are more vulnerable to risk. Different investments behave in different ways and are subject to different risks. Saving your money in a range of assets helps reduce the loss, should one of your investments suffer a downturn.

A need to diversify

There is also a need to diversify within each type of investment. This is especially important in the case of share and bond investing, but can even be true of cash, where the risks are generally lowest. Putting all your money in one deposit account runs the risk that the interest paid on that account will change relative to other accounts. This could mean that the interest you receive is no longer as good as when you originally invested.

It is important to remember that all investments have a degree of risk. Even choosing not to invest is risky. The key is to get the right balance. Most people need a mix of assets in order to achieve their goals. The mix required depends upon individual needs.

By spreading your investments over a wide range of asset classes and different sectors, it is possible to avoid the risk that your portfolio becomes overly reliant on the performance of one particular asset. Key to diversification is selecting assets that behave in different ways.

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Different ‘styles’ of investing

Some assets are said to be ‘negatively correlated’, for instance, bonds and property often behave in a contrarian way to equities by offering lower, but less volatile returns. This provides a ‘safety net’ by diversifying many of the risks associated with reliance upon one particular asset. It is also important to diversify across different ‘styles’ of investing, such as growth or value investing, as well as across different sizes of companies, different sectors and different geographic regions.

Growth stocks are held as investors believe their value is likely to grow significantly over the long term, whereas value shares are held because they are regarded as being cheaper than the intrinsic worth of the companies in which they represent a stake. By mixing styles that can out- or under-perform under different economic conditions, the overall risk rating of the investment portfolio is reduced. Picking the right combination of these depends on your risk profile, so it’s essential to seek professional advice to ensure that your investment portfolio is commensurate with your attitude to investment risk.

A ‘paper loss’

The important thing to remember with investments is that even if your investment goes down, you will only actually make a loss if you cash it in at that time. When you see your investment value fall, this is known as a ‘paper loss’ as it is not a real loss until you sell. If you are going to invest, you need to be prepared to take some risk and to see at least some fall in the value of your investment.

While all investments carry an element of risk, the amount of risk you take directly affects any potential returns and losses. Generally speaking, if there is less risk to your investment, your money will grow more slowly and with more risk your investment may fluctuate more.

Currency risk

You should also be aware of currency risk. Currencies, for example, sterling, euros, dollars and yen, move in relation to one another. If you are putting your money into investments in another country, then their value will move up and down in line with currency changes as well as the normal share-price movements.

Another consideration is the risk of inflation. Inflation means that you will need more money in the future to buy the same things as now. When investing, therefore, beating inflation is an important aim. Investing in cash may not beat inflation over the long term.

All financial investments involve an element of risk. The value of your investment and the income from it will vary and your initial investment amount cannot be guaranteed. Past performance is not a guide to future performance and should not be the sole factor of consideration when selecting a product.

We can help you make informed decisions about the investment choices that are right for you by assessing your life priorities, goals and attitude towards risk for return. Any number of changing circumstances could cause your wealth to diminish, some inevitable and some unpredictable – new taxes and legislation, volatile markets, inflation and changes in your personal life. Structuring your wealth in a way that minimises the impact of these changes is essential. To discuss your requirements, please contact us.

The fund value may fluctuate and can go down as well as up. You may not get back your original investment. Past performance is not an indication of future performance. Tax benefits may vary as a result of statutory change and their value will depend on individual circumstances. This is for your general information and use only and is not intended to address your particular requirements. It should not be relied upon in its entirety and shall not be deemed to be, or constitute, advice. Although endeavours have been made to provide accurate and timely information, Goldmine Media cannot guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No individual or company should act upon such information without receiving appropriate professional advice after a thorough examination of their particular situation. We cannot accept responsibility for any loss as a result of acts or omissions taken in respect of any articles. Thresholds, percentage rates and tax legislation may change in subsequent Finance Acts.