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EVERGREEN ESSENTIALS

DIVERSIFICATION

Diversification allows investors to decrease investment risk with little or no cost to investment performance over the long-term. It is an investment strategy that involves dividing a portfolio among a variety of different investments, instead of only one or just a few similar investments. In other words, “don’t put all your eggs in one basket”.

What does variety mean in this context? It means investments that have different risk and return characteristics.

For example, if an investor has a portfolio of shares in two very similar companies, such as say Coles and Woolworths, those companies will have similar risks and will tend move in the same direction at the same time. This portfolio is not well diversified.

If the investor adds a company or other investment with very different risks and whose price moves quite differently, such as BHP, the portfolio will be better diversified.

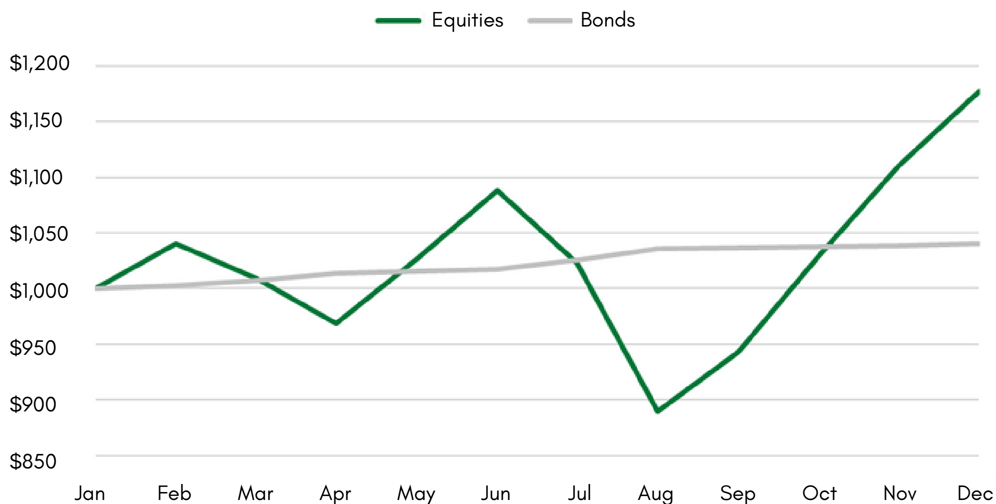
How diversification benefits investors

Diversifying an investment portfolio well means that an investor will avoid making large bets on assets with similar risks. The danger of doing this is not to be underestimated.

An investor might be tempted to invest their entire portfolio in just one investment, as they believe it will perform strongly. However, that one investment may have unique risks which may make it possible for the investor to lose a large amount of money if it performs poorly.

To visualise this, consider two portfolios. The first is 100% equities and the second 100% bonds. The hypothetical returns to each are shown in Chart 1.

Chart 1: Undiversified Portfolio Returns

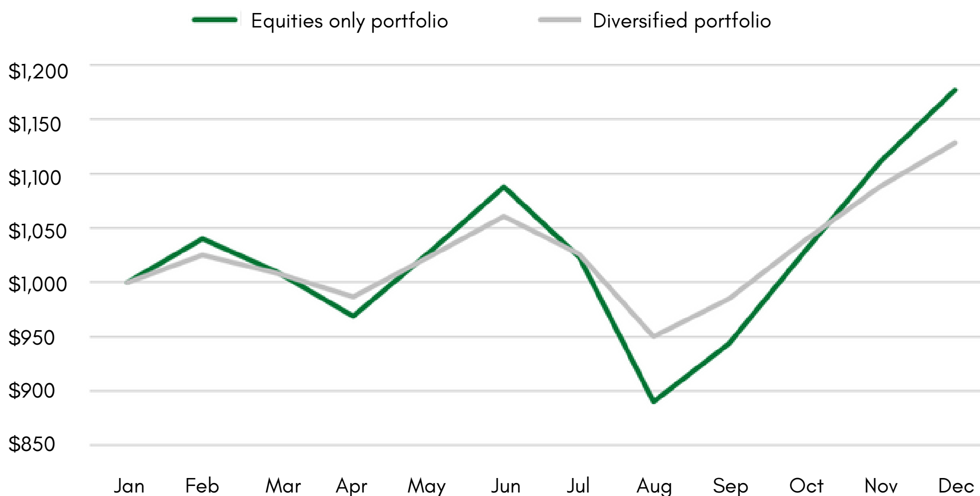


Of the two asset classes, equities provided the highest return over the year, but were also the most volatile while bonds provided the least return but were the least volatile.

It is important to note that over the period, the two asset classes didn't always move in the same direction, which means an investor could potentially benefit by combining them to create a more diversified portfolio.

Chart 2 shows the performance of an equities only portfolio and a diversified portfolio consisting of 60% equities, and 40% bonds.

Chart 2: Diversified vs. Undiversified Portfolio Returns



The diversified portfolio experiences much smaller falls than the equities portfolio through the period, while still generating a strong return.

An investor may still view the equities only portfolio as a more attractive investment, as it provided the highest year-end return, regardless of the volatility. It is important to note, however, that market falls can be much larger, and last much longer, than those in the above scenario.

Our investor may, or may not, still be correct in viewing the equities only portfolio as the better investment. This should depend on their time horizon.

The Takeaway

Some level of diversification is advantageous to all investors. How much depends on many factors and will vary from investor to investor, dependent largely on time-horizon and tolerance to short-term losses.

Ultimately, you should discuss diversification and your risk tolerance with your advisor, to ensure your strategy suits you and your financial needs.

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