The Benefits of Diversification

Diversification is one investment strategy that truly is easy to understand, and can provide important benefits for all investors.

"Diversification", for the layman, simply means not having all of your eggs sitting in the same basket. By spreading out your eggs among two or more baskets, the risk is diminished that one bad egg, or one dropped basket, will ruin all of your eggs. For investing, the same principle applies. By having a mix of investments in different asset classes, such as fixed income (money market and bond funds) or equity (stock) investments, you reduce the risk that all of your investments will suffer if one specific class of investments is not performing well.

The advantage of spreading your investments between more than one asset classes is that each class contains a different level of risk, and potential for returns. Fixed income investments are typically lower risk investments and can help bolster your overall returns when equities are not performing well, and vice versa. Thus, risk is managed by reducing the impact that one poor performer could have on your entire retirement savings.

Research has shown that that different asset classes, such as bonds, money market funds, stocks, and equity investments, perform differently at any given time. Bonds have historically done well when interest rates are falling and inflation is low. When interest rates are low, stocks are usually thriving. The fact that stocks and bonds historically flourish under differing market conditions is why the benefits of diversification can be attributed. So when there is a general downturn in the stock market, bonds often are good investments—and vice-versa. Another example of how diversification can create benefits is by investing in various economies. An economic downturn in the Canadian economy may not affect Japan's economy in the same way; therefore, having Japanese investments would allow an investor to have a small cushion of protection against losses due to a Canadian economic downturn.

By spreading your investments among a variety of asset alternatives, you can reduce the effect of any one negative result on your whole portfolio so you end up with lower overall investment risk. The structure of a well-diversified portfolio is designed to perform reasonably well in nearly all circumstances. Over time, that kind of performance will lead to a secure retirement.

But is diversification truly a valid approach that every investor should take advantage of? If we look at an example of someone with retirement on the horizon, who has no other source of income, they are not usually willing to take much risk. Their need is not to increase wealth, but to preserve it, while living on the income it produces. The retirement years may be as much as one-third of our lifetimes, so the soon-to-be-retiree will still want investments to grow, but the need to preserve wealth will require a low-risk outlook that will dictate how to allocate the assets. They'll want to place a significant portion of assets in bonds to generate a steady source of retirement income for the remainder of their life.

By contrast, a young person wants to build savings, and because of the longer time-line until those assets will be needed, they can afford to take on more risk than the almost-retired person. Younger investors will typically allocate most of their savings into equities because this asset class, under reasonable market conditions and based on history, will provide the greatest opportunity for growth over the long term. However, even though the younger person is able to take more risk, they would still like to smooth out those inevitable periods when the stock market is down. Using diversification, they are therefore wise to allocate some money

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to fixed income investments, but a much smaller portion than the almost-retired person.

So you have now taken the time to review your investments, spoken to your financial advisor, and made changes to diversity your portfolio. Now what? It's a good idea to periodically review your investment plan. Because different investments grow at different rates, and as markets change, so will your percentages change over time. As the percentages change in each fund, they may no longer match the risk profile that you were striving for. You then have to "re-balance," or bring your target fund mix back in line with your original objectives. For instance, let's say you had a target fund mix that was 30% Canadian Equities, 20% in Foreign Equities and 50% Bonds. A year later, you found that the mix had changed because Canadian Equities and Foreign Equities had performed better than Bonds. Your fund mix is now 40% Canadian Equities, 25% Foreign Equities and 35% Bonds. You will want to bring this fund mix back in line with your target mix.

Diversifying investments is an investment strategy that has many pros, and few cons, for investors of any age. It is inevitable that the stock markets will, at one time or another, experience turbulence, but it is the depth and height of those peaks and valleys that investors can have a degree of control over through diversification. To summarize, you can achieve the following potential benefits by using this strategy:

- Create more stability and protect your investments against downturns
- Provide more opportunity for growth at a lower level of risk
- Preserve wealth for those who are approaching retirement
- Peace of mind that you are not ignoring your retirement savings

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