TOWN CLOSE
Financial Planning

Investment diversification

future proofing your finances

TOWN CLOSE
Financial Planning

INVESTMENT DIVERSIFICATION

This is one of a series of short papers covering various aspects of investing.
The others are "Risk", "Investment expectations" and "Investment strategy".

The two pillars of any sensible investment strategy are asset allocation and diversification. Get either wrong and you run the risk of turning your investments into a betting pool.

Both diversification and asset allocation, done correctly, should reduce the overall level of volatility (upwards and downwards) that your investments experience.

That, in turn, means you're much less likely to blow your financial plan up when the next stock market shock comes along. And that's a very good thing.

Asset allocation is the mix of equities, bonds, property, commodities and cash.

This is a note on diversification, here are the six things you should be aware of:

1. Diversification spreads your money amongst different styles (e.g. growth vs value), sectors (e.g. banking vs technology) and geographies (e.g. the UK vs overseas). Each of these have historically had different cycles. Growth tends to cycle in contrast to value, large cap to small cap, and different regions do better at different times.

2. The purpose is to suppress the short- to medium-term volatility of the overall portfolio, while earning the full returns of everything over the long-term.

3. Of course, in efficient markets, whatever suppresses volatility must commensurately suppress return. True diversification will always mute returns at any given moment. But this isn't a flaw; it's proof you're on the right track. You must keep your eyes on the prize: the full return of all the components over the long-term.

4. In a genuinely diversified portfolio, something is always “underperforming.” That’s how you know you’re properly diversified.

5. The last thing on earth a rational investor would ever do is to sell investments that are already down to buy the ones that are already up. This would have the effect of destroying diversification. And it isn’t investing; it’s speculating. It’s the very worst imaginable species of performance-chasing.

6. And, most years, via the free lunch that is rebalancing, you can harvest some of the gains in your winners and reinvest them opportunistically in the laggards.Diversification (and sticking to it) is a character trait. Like all good investment habits, it’s tortoise-like, rolling on serenely, year after year.

Properly diversified clients don’t get “great years”; instead they get a great life.

By embracing diversification we acknowledge an irrefutable truth; although we have a very good idea what will happen over the long run, we never know what’s going to happen next.

And neither does anyone else; the difference is we’re delighted to admit it.