North Star
financial consultants

The benefits of diversification

Diversification is defined as the spreading of your portfolio across different asset classes, including equities, bonds, property, alternatives and cash. The main objective is to reduce the risk in your portfolio compared with that of investing in just one asset class.

Why invest?

First and most importantly, cash does not protect against inflation. Despite a relatively benign inflationary environment, a pound still buys you a lot less now than it did twenty years ago. Secondly, if you are investing for the long term, taking more risk could actually bring you greater returns, although this is not guaranteed and you could lose your investment.

In theory, this is all very well but equities, bonds and the income that they can earn you may go down in value as well as up. How do you go about ensuring you get the best return you can whilst also ensuring you don't lose the lot? One possible theory that may help is diversification – and this Guide provides an introduction to the theory which can help you make the most of that opportunity during times of change.

What is Deversification?

Diversification is defined as the spreading of your portfolio across different asset classes, including equities, bonds, property, alternatives and cash. The main objective is to reduce the risk in your portfolio compared with that of investing in just one asset class.

In theory, the fact that your investment is spread across different types of asset means that when one asset is underperforming, the positive performance of another asset may help to compensate for it. The long-term nature of portfolio planning means that all asset classes are likely to have their ups and downs from time to time. Diversification means you don't have to get wrapped up in worrying about which one you should be in – or out of – at any particular time. However, you should continue to monitor your investments regularly.

Building a portfolio - the process in summary
- Talk to your financial adviser
- Consider the investment amount
- Evaluate the term of the investment
- Assess your attitude to risk
- Account for your personal circumstances
- Allocate proportions to different asset classes
- Select underlying funds, stocks and shares
- Review position regularly

North Star
financial consultants

The benefits of diversification
(cont'd 2)

Introducing the asset classes

There are five main asset classes: cash, bonds, property, equities and alternatives.

Cash

Cash may provide a level of security of capital and an income which varies with interest rates. It is therefore a good idea to hold a decent amount of money in cash for your short-term needs. However, over time inflation may impact the real value of your money – i.e. its ability to buy a given basket of goods. For the cautious amongst us, there are ways you can manage your cash better to reduce this risk. First, always shop around and ensure you are getting the best rate on your savings.

Bonds

Bonds are generally accepted as the next step up from cash in terms of risk. They are designed to provide investors with a fixed level of income (interest) and then full return of capital on a pre-agreed future maturity date. Consequently, during the life of a bond, if interest rates go up, an existing bond becomes less attractive and its capital value on paper will fall. Conversely, if interest rates go down, an existing bond paying higher interest will become more attractive and its capital value would therefore go up.

Despite their accepted position towards the lower end of the risk scale, the asset class contains many different types of bond, offering quite different levels of risk and potential reward:

a. Government bonds

As the name suggests, these are bonds issued by governments. In the UK, these are known as gilts and in the US, as treasuries or T-bonds. Government bonds are loans issued to fund public spending or investment. In return for lending money, the investor receives their pre-agreed rate of interest and is repaid their capital on the pre-fixed maturity date, perhaps 15+ years in the future. Gilts are considered amongst the lowest risk of all bonds because the UK Government is considered a highly credit worthy borrower who has never defaulted on interest payments to Investors.

However, not all government bonds are the same. Higher risk governments also issue bonds and there have been notable disasters. The most recent was Argentina, where the Government defaulted on its obligations during the economic crisis of 1999-2002. Russia has done the same and emerging market countries are also considered to be outside the remit of any investor seeking stability and long-term reassurance.

b. Corporate bonds

Corporate bonds are loans issued by companies, usually for future developments or investment (takeover) opportunities. Like governments, companies pay investors a pre-agreed rate of interest over the life of the bond and then pay back the original capital investment in full at maturity.

The amount of interest paid by a company will be based on the current level of interest rates and the risk of the company going bust. Different companies will have differing levels of existing borrowing, different prospects and different credit histories, each of which affects the way investors assess the risk. The higher that overall risk, the more the company will have to pay to attract investors.

To help less informed investors make decisions, most bonds are rated by independent agencies such as Standard & Poor's or Moody's. Generally, bonds from a highly credit worthy company with a good history will win an A++ or AAA rating, with the grading then scaling down alphabetically through A, BBB, B, CCC and below.

As an overview, any company or bond rated AAA, AA, A or BBB is classified as 'investment grade'. Those rated BB and below are considered 'high yield' because their risk levels mean higher interest payments are needed to attract investors. At the bottom of the scale, CCC and below, these bonds should be avoided by all but the most adventurous and experienced investors. They can carry a default risk in excess of 50% and are sometimes referred to as 'junk bonds'. Please also be aware there are other bond instruments that may be available in the market.

North Star
financial consultants

The benefits of diversification
(cont'd 3)

Property

Property is generally seen as the next risk level up on the scale. For many investors, the exposure provided by their own property might be considered enough. However, for those looking to extend their exposure, or who want a medium risk investment opportunity which might also provide a decent income, property offers its own benefits. There are two types – commercial and residential – and they behave in slightly different ways.

Commercial property is property used by businesses and is split into three main types - retail, industrial and offices. It offers a consistent, long-term income stream, based on long-term rental/lease agreements, with the possibility of some capital growth depending on demand. Individual properties are high value investments with long lead times and therefore most individual investors access this sector via mutual funds.

Residential property has a lower ticket value and slightly shorter lead times (although still a matter of weeks). Buy to-let provides rental based income but leases are shorter and capital values are reliant on individual tastes – which can impact values widely, even within the same street.

Whichever option you go for, property must be considered as a long-term investment and future returns should not be expected to be as high as they have been in recent years. The commercial sector in particular is very specialist and it is therefore recommended that advice is sought from an expert before any decision is made.

Equities

Equities are probably the best known assets, even if they are not the most widely understood. When you buy an equity, you buy a small share in a company and the value of that share will then become reliant both on the performance of the company concerned and on sentiment within the market as a whole.

Equities are considered high risk because their prices are volatile, varying constantly as investor sentiment shifts. Even when the performance of a company individually might be good, if the outlook for the economy is negative, the share price could fall as wider pessimism stops investors from buying.

However, over the long-term, equities have tended to provide higher returns than the other asset classes. This is, of course, based on an average investment across the stock market where corporate profits tend to outperform inflation over the long-term. Short term, however, there will be some years when this is the case and others when they miss targets, the latter of which will cause prices to fall. In addition, even while the overall market does well, there will be individual companies which do badly.

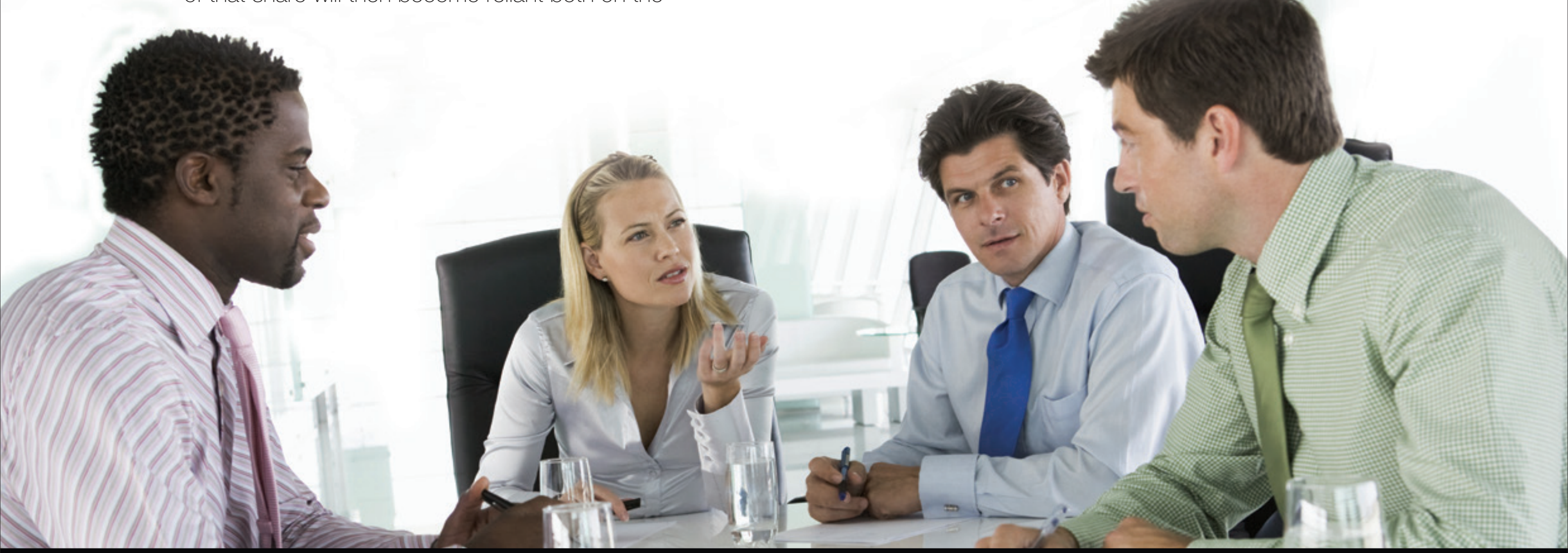
There are also sub sectors which carry a greater risk, such as smaller companies or those in emerging markets. Equities should not be considered unless you are comfortable with what these ups and downs might mean for your investment over shorter periods.

There are also derivative instruments that fund managers may employ for efficient portfolio management and as investments in their own right.

Alternative asset classes

One final way to improve the investment mix of your portfolio is to include alternative asset classes. However, these are only suggested for the most sophisticated of investors as they also, individually, carry a significantly high – and sometimes a difficult to understand – level of risk. Any alternative asset class should only make up a relatively small part of your portfolio.

Alternative assets might include hedge funds, private equity, wine, art, classic cars and antiques. All are very specialist areas, distinct from each other. Even within the single term 'hedge fund' you will find an enormous range of different investing strategies from hundreds of different funds, some of which may be based in unregulated, offshore environments with no transparency and little come back if things go wrong.



North Star
financial consultants

The benefits of diversification
(cont'd 4)

Achieving diversification

Core and satellite is an easy to understand approach which will create a diversified portfolio.

Basically, this means building a safer, long-term investment as a 'core' and then adding on racier investments around the edge. The riskier 'satellite' investments can be shifted around more actively as market conditions change.

However, while this works to reduce an investors' vulnerability to individual holdings, there are certain risks, particularly in the equity market, which this strategy won't address. In the last bear market, sophisticated investors didn't lose as much money as their less skillful rivals, but they still lost money. One way to reduce risk in a portfolio in a declining equity market is to ensure you also hold other, uncorrelated assets, although this is not guaranteed.

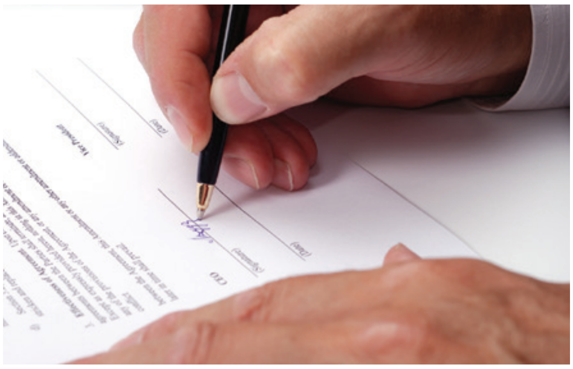
It used to be that investors could diversify UK equities by simply investing in foreign markets. But global markets increasingly move in line with each other, often following the lead of the US. Now investors have to look further afield. Returns from government bonds and investment grade corporate bonds are only lightly correlated with equity markets. Their prices will tend to move according to the interest rate cycle and, in the case of corporate bonds, investors perception of the likelihood of default. This means the inclusion of investment grade corporate bonds and government bonds in a portfolio may help lower the risks and smooth out the returns of an otherwise purely equity portfolio.

Clearly there have been times when both equity and bond markets have fallen at the same time. This is when property, cash and alternative asset classes comes into their own. These may generate – or simply consolidate returns when the rest of your portfolio is suffering.

Of course, there is also danger in too much diversification as you could diversify away all your excess return. A balanced portfolio, appropriate for your age, expectations and attitude to risk, is the ideal way to begin investing.

The best thing for any investor to do is to speak with a financial adviser who can assess your current position and make recommendations.

Building your portfolio



Now you know the assets, you need to work out how they will fit together to best achieve your goals.

Here the process becomes quite personal as the exact mix will depend on your age, the term of your investment, your goals and your attitude to risk. The best thing to do is to speak to a financial adviser.

Generally, if you are investing for the longterm, perhaps for a pension, one strategy is to hold more of your portfolio in high-growth assets such as equities. You can then shift progressively into lower risk assets such as bonds or cash as you draw nearer retirement, so a sudden downturn in the equity market does not dent your pension at the last minute.

In practical terms, the premise of diversification is simple: If you have one share and the company goes bust, you lose all your money; If you have two different shares and one goes bust, you still have half your money. If you have twenty different shares and one goes bust, you still have 95% of your money. For this reason, collective investment funds are a useful tool as money is pooled with that of other investors and managed by a professional fund manager.

These can provide access to the fortunes of perhaps 50 or even 100 shares for a relatively small sum.

Important Information

You can't predict future performance by looking at past performance. The value of investments, and the income from them, can go down as well as up, and you may not get back what you put in. Information contained in this article is positioned around individual stocks and shares that may be combined to form a portfolio. Some investments may be investment vehicles that collectively will invest in a number of individual stocks.

The contents of this document do not constitute advice and should not be taken as a recommendation to purchase or invest in any financial product. If you are unsure about anything you should speak to your financial adviser. If you have any questions about your own portfolio or would like to discuss the best mix of investments to meet your needs at this time, please speak to your financial adviser.