What is a diversified portfolio? Part 2

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Having introduced asset diversification in the first article, this piece focuses on geographical spread, also known as global diversification.

Geographical spread is becoming more and more important as the major world economies become increasingly intertwined. Although technology has made it much easier to achieve, it's not just as simple as placing money into assets within different countries! Each country's financial instruments will have different characteristics depending on how developed they are, what you are buying and also the political situation within the country.

In investment terms, countries are generally split into three different pools depending on the economic characteristics.

Developed markets

As the name suggests, developed markets refers to the most developed countries in terms of their economies. Companies operating in these markets tend to receive higher amounts of income and have an openness to foreign ownership, in turn creating a global economy. These countries include the UK, USA, France and Germany.

Investing in developed markets will typically give you lower returns over the long term than smaller economies but should offer more security due to the sheer size of the market.

Emerging Markets

Emerging markets have many of the same characteristics as those defined as developed, but don't quite meet the criteria. This could be down to the size of the economy, lack of foreign influence or due to the lack of liquidity, available short term cash.

Countries falling in to this pool include Brazil, Russia, India and China. Typically, these markets will offer high long term gains but, particularly over the short term, will be subject to high levels of volatility. This will mean that the value of an investor's portfolio will fluctuate a lot over time.

Frontier Markets

Frontier markets are the economies that sit between the least developed countries of the world and the emerging markets. They include countries such as Argentina, Jamaica, Serbia and Ghana. Argentina has recently experienced inflation rates of over 50%, and as such the risk of investing in that country is risky. Frontier markets offer the highest potential returns, however they also carry extremely high risks for investors. It is also worth noting that investing into these countries is difficult and not commonly done.

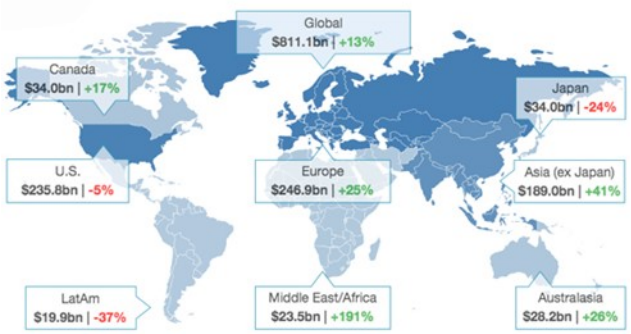
Mixing it Up

This means holding assets in UK, Europe, America, Asia etc. This will allow an investor to benefit from any growing economies and can also shield an investor from any economy having a hard time.

In order to ensure full diversification within these areas can sometimes take some digging. There are "global funds", however these tend to have their own bias and a lot of them have a large weighting towards the US. On the flip side, the exposure towards emerging markets should be monitored due to its volatility.

So what's the conclusion?

When you take the above areas and factors into account, it becomes clear that good financial advice is needed. Asset diversification and global diversification are only the tip of the iceberg when it comes to true diversity and there are other areas that we can cover in future articles (eg. investment styles, derivatives, hedges and spread betting). To take all of this into account when investing your own money would be difficult. It is also worth mentioning that we see a lot of advisers that take the "easy route" when recommending investments and will place all of their clients into the same model for an easy life. By asking a few questions of them you will be able to tell whether or not they have the required knowledge to look after your investments, if not, it may be time for a change.



Different well-diversified portfolios can still have different risk profiles. A low risk investor may prefer a higher percentage left in deposit accounts. There will be a lower overall percentage in equities with a larger weighting to larger blue chip companies primarily in developed countries. A high risk investor would be looking at less money remaining in deposit type accounts and the rest spread through more speculative stocks in the other asset classes.

It is worth asking your adviser about this and they should be able to give you an answer. If you find that most of your shorter term money is invested in Emerging market equities and most of your longer term money is invested in developed market fixed interest securities, then your circumstances have not been taken into account and a review needs to be done.

My view is, as stated in this article and the earlier one covering assets, you should aim to build a portfolio, with the help of a professional, that can withstand pressures in as many market conditions as possible. Bearing in mind that there is an infinite amount of ways to achieve diversification, just ensuring it is in the mind of whoever is looking after your money is important.

What is also very important, but also widely forgotten about, is that, over time, your portfolio will need to be looked at in order to ensure that it still meets your objectives and also to take into account that your investment timescale will reduce as time goes on. As financial advisers, this is something that we see a lot. People are in the same portfolios they were in when they set up plans and they haven't been reviewed in the meantime. This causes investments that may have been perfect for you years ago to be completely unsuitable now and in need of some TLC.

Your investment objectives and goals will alter over time and it's essential to ensure you're always reviewing your portfolio. Your attitude to risk is a key factor, and one which should not be taken lightly. It needs to be considered when deciding on your asset and global diversification with regards to your investments.

It is best to seek independent financial advice before embarking on any investment strategies and the content of this article can not be construed as financial advice.

If you would like to discuss your financial needs with a member of the Hampshire Hill Group Ltd team please call 01623 750000.
