Understanding Diversification

Diversification is a key investment strategy used to manage investment risk and price volatility within a portfolio whilst still providing an appropriate level of return.

The goal of diversification is however not to boost performance. It won't ensure gains or guarantee against losses, but it can help set the appropriate level of risk for an investor's timeframe, financial goals, and tolerance for portfolio volatility.

To diversify an investment portfolio means to invest in a variety of assets and investments that perform differently to each other over time.

You can diversify your portfolio in different ways. Examples of diversification include investing:

- across a range of asset classes including growth assets like shares and property and defensive assets like fixed interest (bonds) and cash
- across different countries and regions such as Australian and international assets, Asia and emerging markets
- across different securities that provide you access to a range of companies and sectors.

The value of diversification

Diversification allows you to participate in the growth and performance of financial markets while reducing risk in your portfolio by moderating the ups and downs in returns over time. This means that you avoid taking big bets in one asset class and/or a few investments that may adversely affect your returns if it that asset class or investment performs badly.

Diversification avoids having your investment fortunes tied to the performance of a small number of securities or assets. It also allows you to have an exposure to a spread of assets and securities and different strategies including both growth and defensive assets.

In essence, diversification provides a greater chance that your portfolio will experience smoother returns over time, by minimising the effects of volatile markets where possible, particularly over shorter periods.

How diversification works

The key to diversification is to invest in assets that have different characteristics and perform differently in varying market conditions. Table 1 shows the Expected Long-term Returns, Volatility and Expected Asset Class Correlations of various asset classes. These assumptions are supplied by the Morningstar Capital Markets team for Centrepoint Alliance and are based on the long term, ie. Multiple decades.

The top half of the table shows the expected long-term returns and the bottom half shows the expected asset class correlations. Australian equities and International Fixed Interest have a low expected correlation at 0.09 and are expected to perform differently in different market cycles. By combining investments with low correlation, investors can improve diversification. This provides a greater chance that your portfolio will experience smoother returns over time, by minimising the effects of volatile markets where possible, particularly over shorter periods.

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Table 1 – Expected Long-term Returns, Volatility and Expected Asset Class Correlations

Expected Long-Term Return and Volatility Assumptions[1]			
Asset Class	**Compound Total Return %**	**Income %**	**Standard Deviation %**
Australian Equity[3]	7.50	4.00	16.50
International Equity (50% Hedged)	7.25	2.50	13.00
Australian Listed Property	6.50	5.50	16.50
International Listed Property	6.75	4.00	18.00
Global Infrastructure	6.75	4.00	13.00
Diversified Alternatives	5.25	0.00	6.50
Australian Fixed Interest	3.75	3.75	5.25
International Fixed Interest	4.25	4.25	5.00
Cash	3.25	3.25	1.75

Expected Asset Class Correlations[1]	Australian Equity	International Equity	AREITS	GREITS	Global Infrastructure	Diversified Alternatives	Australian Fixed Income	International Fixed Income	Cash
Australian Equity	1.00	0.69	0.64	0.68	0.66	0.50	0.09	0.09	0.02
International Equity (50% Hedged)	0.69	1.00	0.44	0.67	0.68	0.45	0.05	0.05	-0.02
Australian Listed Property	0.64	0.44	1.00	0.67	0.65	0.50	0.18	0.15	0.01
International Listed Property	0.68	0.67	0.67	1.00	0.79	0.50	0.11	0.23	-0.06
Global Infrastructure	0.66	0.68	0.65	0.79	1.00	0.50	0.10	0.19	-0.02
Diversified Alternatives	0.50	0.45	0.50	0.50	0.50	1.00	0.20	0.20	0.00
Australian Fixed Interest	0.09	0.05	0.18	0.11	0.10	0.20	1.00	0.67	0.25
International Fixed Interest	0.09	0.05	0.15	0.23	0.19	0.20	0.67	1.00	0.12
Cash	0.02	-0.02	0.01	-0.06	-0.02	0.00	0.25	0.12	1.00

[1]Income, total return and other capital market assumptions refer to the long term i.e. multiple decades. Over shorter periods outcomes may vary significantly.
[3]Total return incorporates franking. Income return is cash yield.

Source: Morningstar, CPAL

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Effectiveness of diversification

Diversification can reduce the risk in your portfolio but it will not eliminate the risks.

Your portfolio is still likely to experience ups and downs in returns over time, but with a lower level of variability. Your portfolio may have exposure to specific investments that perform poorly at times and you are unlikely to avoid investing in poor performing investments. When reviewing the effectiveness of diversification, you should consider the performance of your total portfolio.

The benefits of diversification will vary over different time periods. Historically, in some periods when the broad financial markets decline, the effectiveness of diversification has reduced. Diversification should therefore be measured over medium to long term periods.