Diversification is Never Out of Style!

*Developing a long term plan to reach your financial goals involves creating an investment portfolio that’s right for you. Let’s take a deeper look at using asset allocation and diversification in your portfolio.*

**Start with asset allocation**

Effective portfolio planning begins with an asset allocation plan designed to achieve the highest return potential for the level of risk that’s acceptable to you. It’s the right place to start because asset allocation – the mix of income (income investments here include cash or cash equivalents), and growth (ex. equity) investments in a portfolio – has been shown to be the key factor in the variability of returns over the long term. In other words, the allocation of investments to each asset class is far more important than the selection or timing of individual investments. During an economic cycle, some investments will perform better than others. For example, during an expansionary phase, corporate profits are healthy and stock prices (equity asset class) are rising. If interest rates are raised to counteract the threat of inflation, investors with bond and mortgage funds (income asset class) will likely see their bond prices decrease. All asset classes rarely react the same way during an economic cycle. However, by selecting investments in each of the asset classes, you can reduce investment risk and increase your return potential. The amount that you put in each asset class depends on your overall desired return combined with the amount of risk you want to take on and how long you intend to invest. As you move up the risk curve, from income (generally lower risk) to equities (higher risk), you have the potential of a higher return but also higher risk. This is what we call the risk/return trade-off. You are the only person that knows what balance is right for you but an investment professional can give you the tools to help you make this decision.

**The five main types of diversification**

Once your asset allocation strategy is established, there are several ways to diversify to further minimize risk and potentially increase returns.

1. **Diversification within an asset class**

With just three basic asset classes, it should be simple to select an investment for each class that matches your investment goals. The problem is that choosing just one investment ties you to the outcome of the chosen investment. What happens if the profits of that company deteriorate, competition appears or management makes poor decisions? A better idea would be to invest in several suitable investments within each asset class. That way, positive performance by one investment may offset poor performance by another.
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2. Geographical Diversification

Since Canada represents about 4 - 5% of the global capital markets, limiting your investments to "domestic-only" means missing out on roughly 95% of the world’s opportunities. Geographical diversification offers the opportunity to invest in many global companies not headquartered in Canada. It also allows for currency diversification. A falling Canadian dollar can enhance the performance of international investments; however, there is also the risk that a rising Canadian dollar could devalue foreign holdings.

3. Industry Diversification

By diversifying within industries, the volatility of certain growth stocks, whose earnings grow above average, can be offset by established market heavyweights and their more stable performances. These stable “blue chip” stocks are not immune to economic downturns, but they have a better chance of maintaining earnings and dividends through good times and bad. You can also diversify by industry sector to balance the differences various sectors exhibit. Cyclical industries such as steel are particularly susceptible to recessionary factors. By contrast, financial services tend to be more conservative when it comes to business risk partly because they are highly regulated. Resource stocks – products such as lumber, minerals, metals, oil and gas – are more likely to be very susceptible to the economic cycle while the utilities sector is typically sensitive to the movements of interest rates.

4. Market Capitalization Diversification

Market capitalization is the total value of a company’s outstanding shares and provides an indication of its financial size relative to other companies. This is used to divide companies into three categories – large-cap companies with global reach, mid-cap companies becoming established in their markets and small-cap companies creating new products and services. The returns of large-, mid- and small-cap equities vary year over year and are unpredictable, so holding investments in each segment can reduce the overall volatility of your investment portfolio.

5. Investment Style Diversification

Investment style is used mainly in mutual fund investments. Each portfolio managers can manage a mutual fund in different ways. Here are a few main examples:

- **Top-down** analysis starts with a broad economic forecast and selects the stocks of companies in the most promising regions and industries.
- **Bottom-up** analysis concentrates on selecting individual stocks that should be successful regardless of changes in the economic cycle.
- **Value investing** involves selecting stocks that trade for less than their intrinsic value. Value investors will search for stocks of companies that they believe the market has undervalued.
- **Growth investing** refers to the selection of stocks in companies that are deemed to have good growth potential. In most cases a growth stock is defined as a company whose earnings are expected to grow at an average rate above that of its industry or overall market.

While all these styles are useful, the best approach is achieved through a combination of styles. While investing is not without its risks, using asset allocation and diversification strategies should help minimize the overall volatility of your portfolio. Speak to your investment professional about getting diversified today.
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The Bottom Line

Investors who tried to pick the best performing investment opportunity would have had difficulty in the last 15 years. As you can see from the chart on next page, various asset classes rarely react the same way each year in an economic cycle. By choosing a variety of investments or diversifying you can reduce the risk in your portfolio by spreading it out. This effectively helps smooth out your returns which may reduce some upside potential but also lowers the probability of consistently investing in the worst performing sectors.

Periodic Table of Asset Class Returns - 15 Years