Private Investment Advice

Diversification is Never Out of Style!

Start with asset allocation

Effective portfolio planning begins with an asset allocation plan designed to achieve the highest return for the level of risk that's acceptable to you. It's the right place to start because asset allocation – the mix of cash/cash equivalents, income and growth 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 of these asset classes 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, holders of Treasury bills (cash/cash equivalents asset class) may benefit, but investors with bond and mortgage funds (income asset class) will see their bond prices decrease. As you can see, the three asset classes do not react the same way during an economic cycle. However, by selecting investments in each of the three asset classes, you can reduce investment risk and increase your returns.

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 exposes you to the risk 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.

2. Geographical Diversification

Since Canada represents less than 3% of the global capital markets, limiting your investments to "domestic-only" means missing out on 97% of the world's opportunities. As many other countries have offered better returns in the past 10 years, a combination of global and

Investors who watched technology stocks and mutual funds roar ahead of other investments in 2000 may have wondered why they should invest in anything else. It appeared that the "old economy" stocks were indeed "old news" and technology was all the rage.

But those same investors who rushed to technology were ignoring the most important investment strategy of all – diversification. While technology or biotech stocks may have been a "trend", diversification is a principle that never goes out of style.

Diversification simply means "not putting all of your eggs in one basket", and it is the best way to reduce investment risk while increasing the potential for higher returns.

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domestic investments can increase potential returns.[1] Geographical diversification also presents the opportunity 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 can be offset by established market heavyweights and their more stable performances. These "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 tendencies the different sectors exhibit. Cyclical industries such as steel are particularly susceptible to recessionary factors. By contrast, financial services are most likely to offset business risk. Resource stocks – products such as lumber, minerals, metals, oil and gas – tend to be very susceptible to the economic cycle. The utilities sector is 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 the process you or your mutual fund portfolio manager use to choose investments. **Top-down** analysis starts with a broad economic forecast and selects the stocks of the largest companies in the most promising regions and industries. **Bottom-up** analysis concentrates on selecting promising 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 diversification strategies should help minimize the overall volatility of your portfolio.

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At TD Waterhouse Private Investment Advice, our strong client relationships are built on a continuing dialogue – listening to your needs, sharing information and recommending investment strategies and opportunities. Your Investment Advisor will work with you to create and implement your investment plan, and will provide ongoing advice with a view to enhancing its success over the long term.

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1 Foreign investments may involve additional risks that need to be assessed, such as political or economic risks and currency fluctuations.

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