Educational series

FRIENDS PROVIDENT INTERNATIONAL

# The importance of Diversification

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At the beginning of each year the question on many investors' minds is 'which financial markets will perform the best over the next 12 months?' In the media, so-called 'investment experts' make their predictions. However, these forecasts may encourage investors to allocate a large amount of their savings to one asset class or geographic area at the expense of others. To reduce portfolio risk, we believe that it is important for investors not to put too much of their money in one asset class, or geographic area. In other words, **investors should diversify.**

Investment experts might be able to suggest potential investment opportunities, but it is more or less impossible for anyone to predict which asset class or geographic area will deliver the best return each year.

The table below ranks the annual returns from each of the main asset classes over the past ten years. As we can see, emerging market equities performed relatively well in 2009 and 2012, but then suffered losses in 2011 and again in 2013. In comparison, US equities have enjoyed something of a revival lately and were the best performers in 2013.

If investors are uncomfortable with making their own investment decisions, they should speak to a financial adviser about developing a suitable balance of investments to match their attitude to risk.

## Annual returns for key asset classes (ranked in order of performance)

Highest return

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| 56.28 | 25.95 | 34.54 | 36.38 | 40.52 | 10.23 | 79.02 | 28.71 | 10.23 | 22.70 | 32.39 |
| 46.98 | 22.42 | 25.63 | 33.74 | 39.82 | 2.23 | 72.53 | 19.93 | 9.58 | 22.54 | 28.74 |
| 43.62 | 21.02 | 23.17 | 33.10 | 24.32 | 1.80 | 51.74 | 19.20 | 8.51 | 18.81 | 27.35 |
| 36.15 | 17.72 | 21.36 | 32.55 | 17.46 | -7.69 | 46.15 | 16.83 | 6.33 | 18.63 | 23.44 |
| 34.63 | 15.95 | 14.03 | 21.53 | 16.23 | -25.47 | 35.41 | 15.59 | 3.53 | 17.46 | 23.09 |
| 34.39 | 15.75 | 11.37 | 16.15 | 12.18 | -29.11 | 33.94 | 15.06 | 2.11 | 16.80 | 7.16 |
| 28.68 | 14.59 | 11.34 | 15.79 | 11.74 | -35.65 | 26.46 | 13.21 | -4.17 | 16.00 | 3.33 |
| 26.00 | 11.40 | 9.13 | 12.57 | 10.57 | -37.00 | 22.84 | 12.84 | -6.86 | 10.81 | -1.45 |
| 23.93 | 10.88 | 4.91 | 7.28 | 7.12 | -41.85 | 18.91 | 11.03 | -13.32 | 8.49 | -2.27 |
| 17.95 | 10.33 | 1.98 | 6.44 | 5.49 | -45.04 | 17.55 | 8.85 | -14.19 | 8.36 | -3.19 |
| 16.17 | 9.15 | 1.33 | 6.33 | 5.24 | -49.39 | 13.58 | 5.90 | -14.49 | 6.05 | -4.30 |
| 14.78 | 6.25 | -1.34 | 3.78 | 3.57 | -52.23 | 6.39 | 3.03 | -17.07 | 1.83 | -9.52 |
| 9.87 | 3.45 | -6.66 | 2.07 | -4.14 | -53.18 | 2.63 | 2.44 | -18.17 | -1.06 | -28.66 |

Lowest return

Key

- **Asia Pacific ex Japan Equities** represented by MSCI AC Asia Pacific ex Japan Index
- **Commodities** represented by Dow Jones-UBS Commodity Index
- **Corporate Bonds** represented by Dow Jones Corporate Bond Index
- **Emerging Market Equities** represented by MSCI Emerging Markets Index
- **European Equities** represented by MSCI Europe ex UK Index
- **Global Equities** represented by MSCI AC World Index
- **Global High Yield Bonds** represented by BofA Merrill Lynch BB-B Global High Yield Index
- **Global Index Linked Bonds** represented by Barclays Global Inflation-linked Index
- **Global Treasury Bonds** represented by Barclays Global Treasury Index
- **Gold** represented by Morningstar Gold Commodity Index
- **Japanese Equities** represented by MSCI Japan Index
- **UK Equities** represented by FTSE All-Share Index
- **US Equities** represented by S&P 500 Index

Source: Morningstar Direct, US Dollar total returns, data as at 31/12/13.
The information shown refers to the past. Past performance is not a reliable guide to future performance.

**All figures in %**

As we can see from the table on the previous page, no one asset class is consistently the best or worst performer year in year out. This illustrates the need to have exposure to a blend of asset classes to help drive long-term performance and reduce the risk of being overly exposed to a single asset class.

### Jargon buster

**Diversification** – A portfolio strategy designed to reduce exposure to risk by combining a variety of investments such as equities, bonds, and property. These assets are uncorrelated and are unlikely to perform in exactly the sameway during similar time periods. A popular approach is to also diversify portfolios by geographic area, because it helps investors to eliminate the risk of investing in one country.

## A word about correlation

Asset classes behave differently and usually independently of each other. So, for example, if the value of one goes up another might go down and vice versa. The extent to which asset classes move together is known as correlation.

When two asset classes have a negative correlation, they will tend to move in different directions (as one rises, the other falls). If they have a positive correlation, the price of these two assets will tend to rise and fall at the same time. The aim for investors is to have a mixture of asset classes that do not tend to rise and fall in tandem. Therefore, at any time, one group of your investments might be doing well, while another might not be doing as well. The key point here is to avoid all of your holdings in your portfolio losing value at the same time.

Asset classes with low or negative correlations are good diversifiers, and could help you to reduce the amount of risk in your investment portfolio.

### Example of a negatively correlated asset

Historically, gold has been considered to be an ideal diversifier for a portfolio, because it is among the most negatively correlated assets available. Factors influencing gold prices are diverse in nature and so the performance of this precious metal tends to be independent of any other asset class.

Gold may help to stabilise portfolio returns even during periods of financial instability. In 2008, as the table on the previous page demonstrates, gold was among the few assets that produced a positive performance, yielding a gain of 2%. Meanwhile, other major asset classes fell by more than 50% during the same period.

Last year was not a good time for gold, whilst other assets, especially developed market equities, performed strongly. The price of the precious metal fell due to the Federal Reserve's plans to begin to reduce the size of its quantitative easing programme before the end of the year. We believe that the performance of gold in recent years highlights the need for investors to have a diversified portfolio.

## Key takeaway

Rather than trying to focus on the next 'hot' investment area, diversifying across asset classes or geographic areas may reduce your portfolio risk and enhance the long-term return potential. Not all asset classes perform in exactly the same way at the same time.

**A number of sources have been used for this document, they are available upon request from Friends Provident International. All information quoted correct at the time of writing (June 2014).**

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