canberra times: q&a

Q 1: It is often said when it comes to investing that you should diversify. Does that really help during times of share market volatility like we are experiencing now?

B.H., Canberra

A 1: Diversification is certainly a key concept to embrace to increase your chances of a successful investment experience, especially during highly volatile times. There are three reasons this helps:

1. Diversify to reduce the risk of permanent capital loss – eg if you had $1,000 invested in XYZ company shares, and XYZ company collapses (due to reasons including poor product or service, poor management, lack of demand or fraud), then your $1,000 investment can be worth nothing once the company has been wound up. To reduce the risk of losing your investment entirely, you could invest your funds across many companies say using a managed fund investing in hundreds of companies.
2. Diversify to reduce the risk of poor performance – eg if you had $1,000 invested in XYZ company shares, and XYZ company has a bad year (due to many reasons including economic environment, legislative changes, increased competition), then the profits created will be lower, dividends paid will be lower and the share price should drop. To reduce the risk of your investment performance outcome being tied to one company that may only be exposed to one sector of the economy (ie banks, paper and packaging, pharmaceuticals, retail, mining) then you could invest your funds across a number of companies across various sectors and industries. Going further, you could invest in companies operating in countries all around the world to gain exposure to the many and varied opportunities that exist. This has more relevance when you consider that the Australian economy only represents less than 3% of global output.
3. Diversify to reduce the risk of excessive volatility – eg if you had $1,000 invested in XYZ company shares, and XYZ company drops sharply in value, then your whole portfolio has dropped in value. If this drop is greater than you are prepared to handle, then you may choose to sell out your shares and sustain a large capital loss on your investment. If instead, you held a number of shares in various companies operating in different sectors and geographic locations, then the movement in value of your investment will be less extreme, which can make it more "comfortable" to ride out any downside volatility.

These 3 benefits of diversification are clearer when you consider investment in a small number of companies compared to a fund investing across the global sharemarket - There is no risk of permanent capital loss (ie no chance the thousands of underlying companies that make up a sharemarket will all collapse at one time), you deliberately achieve an average return (without the extreme highs or lows) and you are deliberately less volatile (compared to the movement of an individual company).

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So, in short, when it comes to investing (being the patient and passive accumulation of wealth over time), diversification is essential as a risk management tool. Taken to the extreme of investment diversification where you essentially use global index funds, then very effective diversification can be achieved. This would allow you to invest in a way that ensures you will get a return "of" your money first, before then achieving a return "on" your money.

By contrast, if you purchase assets in a concentrated manner (ie 100% in one company say, hoping for short term gain) then this is speculating rather than investing.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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