

## **Diversification is critical to reduce investment risk**

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FINANCIAL PLANNING TIPS

Published Monday March 24th, 2008

Appeared on page B3

I'm often asked how important diversification is to one's portfolio. I hope to clarify this issue once and for all in this column.

One of the basic propositions in finance is that a lot of the risk attached to investments is unique to that particular investment.

By diversifying, you remove these unique risks and all that you're exposed to are the market risks -- the general market movements.

Managing risk, or the volatility of returns in a portfolio, is an essential element in effective portfolio construction. Assembling diverse investments will lower volatility, or risk, and help you shield your portfolio from the full impact of sharp, short-term market movements, such as we've been experiencing over the past number of months. This in turn helps you to remain focused on your long-term goals rather than being distracted by sudden, dramatic movements within your portfolio.

Diversification offers very important benefits when you are choosing investments to minimize risk in a portfolio. The idea is that your risk tolerance reflects how much risk you can tolerate in your portfolio. Diversification should allow you to obtain a higher return when conforming to that risk tolerance.

Most investment advisors embrace the idea that diversification plays a key role in portfolio performance and helps to soften the ups and downs of each individual investment.

Thus, diversification is now entrenched as one of the cornerstones of investment management. It's a key way to reduce your risk and generate above-average risk-adjusted returns. It's probably as important, if not more so, than security selection itself.

Diversification is effective at reducing risk, without necessarily sacrificing returns, because each investment tends to follow its own unique performance path.

If three randomly selected investments start out priced at \$10 a unit, after 5 years their individual trajectories may lead Investment A to reach \$37, Investment B to achieve \$19, and Investment C to drop to \$7. The average performance of the three investments is \$21, so holding all three investments would provide returns that are lower than top-performing investment A's results, but higher than either Investment B or Investment C's individual returns.

The secret of successful diversification lies in the correlations between investments -- or to what extent their returns move together over time.

Investments with correlations of 1 move in tandem, and offer no diversification benefits. Investments with positive correlations between 0 and 1 tend to move in the same direction, but do offer the opportunity for diversification, especially as correlations drop closer to 0. Investments with negative correlations between 0 and -1 generally move in opposite directions and offer the greatest potential diversification benefits through changing or volatile market conditions.

In general, investments within one investment management style, asset class, region or market capitalization will have relatively high correlations.

Diversification among these categories allows a portfolio to benefit when different categories of investments are outperforming. It's important to keep in mind that low correlations alone won't necessarily lead to a portfolio with an appropriate risk level. An investor can pick five funds that have very low correlations with each other, but if they're all very risky asset classes -- for example, a small cap, micro cap, US small cap, emerging market and high yield debt fund -- that portfolio will be risky. It's the old trade-off between risk and return. Investors must always be mindful of the volatility of the underlying funds.

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