Diversifying Your Investments Will Not Eliminate Risk

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It occurred to me recently that individual investors may perceive their "diversified portfolio" to be less risky than it really is.

Finance professionals define risk as the probability that an asset's returns will be less than expected. This probability is often estimated by observing historical fluctuations (deviations) in an asset's returns. The more widely the asset's returns have/will vary, the riskier it is.

Financial advisors often recommend that their clients diversify their investment portfolio (and rightly so), with the goal of providing the highest return for the lowest combined risk. Asset-specific risk can be "diversified away" through selecting individual assets that react differently to market forces. For example, a retail business and a gold business will react differently to an economic depression (retail businesses suffer, gold prices usually increase).

Investors diversify firstly by asset class (shares, property, cash) and by asset type (e.g., shares can be classified into sectors, such as retail, resources, industrials, technology, etc).

Diversification will not eliminate the risk of the entire market/economy. Whether you held shares or property over the last two years, it's likely that your capital returns were negative. Even bonds suffered, due to increases in market perceptions of credit risk.

Diversification is sensible, but you must ensure that your strategy is consistent with your overall risk tolerance, financial goals, and age. As you near retirement, your risk tolerance should be reduced. You cannot afford to suffer significant variations in the value of your investments, if you will need to draw on those investments in the near future, to fund your retirement lifestyle. Whilst a riskier portfolio might achieve higher returns over the medium-long term, these returns are useless if you are not alive to spend them! Instead, consider reducing your exposure to shares and even (gasp!) property as you near retirement.

Those of us with many working years ahead can perhaps afford to chase higher returns, and endure higher risks. However, it's hard to have faith in diversification as you watch the value of your investments plummet. There is another school of thought on investing, made famous by Warren Buffet: "Wide *diversification is only required when investors do not understand what they are doing.*" I will cover this alternative approach in the next column.