Prudential Investment Managers
JUNE 2018

Diversification: Get the balance right

You know the old saying, 'Don't put all your eggs in one basket'. In life – or at least in the farmyard – it's smart advice, helping you to reduce your risk of losing everything if disaster strikes (for example, if you drop that basket and crack all your eggs). There's wisdom here for the investor, too – but while diversification can play a vital role in your investment portfolio, you need to do it for the right reasons… and you need to do it the right way.

Unfortunately, many people don't. Diversification can be a challenging concept to understand, so it's worth unpacking what it is, what it does, and how – if you get it right – it can help you achieve your investment goals.

In investment planning, portfolio diversification is a strategy where you combine a variety of assets to reduce the overall risk of the portfolio. The idea is that, rather than concentrating your investment in one stock, one fund or one sector, you spread your exposure – and your risk – around. That way, if that stock, fund or sector were to suffer a serious downturn, your portfolio will be able to absorb the blow.

The upside is that you're reducing your risk. The downside, meanwhile, is that while diversification smooths out your risk, it can also reduce your returns over time.

A common mistake among new investors is to diversify their investments across a range of financial managers. The reality, though, is that if the underlying assets are all the same (in other words, if the different managers all invest in the same things), you're no better off than you would have been with just one manager. You're only duplicating your existing exposure. In this case, your investment eggs are all still in the same basket. This is especially true in smaller markets like South Africa.

Remember, when it comes to diversifying you need to choose assets that don't just look different, but that behave differently to each other.

What's the best way for a new investor to get diversification right? You need to get exposure to a variety of assets that have either a negative or neutral correlation to each other. Or, to put it simply, you'll want exposure to assets that react differently to the same economic event. When one asset goes down, the other one will either remain static or go up. This lowers your overall risk, because no matter what the market does, you'll have some assets that benefit even if others are negatively affected.

It can be very difficult to know which shares are influenced by different stimuli, or which asset classes tend to behave differently relative to each other. Fortunately, as an investor you don't really have to worry about that, because your fund manager will take care of that for you. Multi-asset funds are designed to offer exposure to a combination of asset classes, and those asset classes are carefully chosen to complement each other in certain respects. Prudential's multi-asset unit trusts include the Balanced Fund, the Inflation Plus Fund and the Enhanced Income Fund.

Speak to your financial adviser about the best way to determine your asset allocation based on your personal investment goals, your time horizon and your risk profile. Your adviser will then help to adjust this over time, as markets move, ensure you're still getting the appropriate levels of diversification, while keeping your portfolio in line with your personal objectives.

If you aren't already investing with us, contact your Financial Adviser or our Client Services team on 0860 105 775 or at query@prudential.co.za