INVESTMENT PLANNING COUNSEL'S
Intelligent Investor

Live *your* dream.

The Importance of Diversification in Difficult Times

The global stock markets are down; this is a fact that we really don't have to dwell on too much. You can't turn on a TV, read a newspaper or talk to a five year old without hearing about the state of almost everyone's investments. We can't change the fact that the markets are down but we can learn from it. One investment strategy that saved many investors during this difficult time was the diversification of their investment portfolios.

Now, diversification may be a familiar term to most investors. Diversification can be summed up with this phrase: *"Don't put all of your eggs in one basket."* While that sentiment certainly captures the essence of the issue, it provides little guidance on the practical implications of the role diversification plays in an investor's portfolio and offers no insight into how a diversified portfolio is actually created.

"The more diversified the less dependence you may have on any one security."

What is Diversification?

Taking a closer look at the concept of diversification, the idea is to create a portfolio that includes multiple investments in order to reduce risk. Consider, for example, an investment that consists of only the stock issued by a single company. If that company's stock suffers a serious downturn *(i.e. Nortel),* your portfolio will sustain the full brunt of the decline and can cause significant losses. By splitting your investment between the stocks of two different companies, you reduce the potential risk to your portfolio. Therefore the more diversified the less dependence you may have on any one security.

Another way to reduce the risk in your portfolio is to include other asset types into your portfolio. As an example, many investors also add asset classes such as bonds and cash. Because cash is generally used as a short-term reserve, most investors develop an asset allocation strategy for their portfolios based primarily on the use of stocks and bonds. It is never a bad idea to keep a portion of your invested assets in cash, or short-term money-market securities. Cash can be used in case of an emergency, and short-term money-market securities can be liquidated instantly in case an investment opportunity arises, or in the event your usual cash requirements spike and you need to sell investments to make payments.

Also keep in mind that asset allocation and diversification are closely linked concepts; a diversified portfolio is created through the process of asset allocation. When creating a portfolio that contains both stocks and bonds, aggressive investors may lean toward a mix of 80% stocks and 20% bonds while conservative investors may prefer a 20% stocks to 80% bonds mix.

Regardless of whether you are aggressive or conservative, the use of asset allocation to reduce risk through the selection of a balance of stocks and bonds for your portfolio is a more detailed description of how a diversified portfolio is created than the simplistic eggs in one basket concept. With this in mind, you will notice that mutual fund portfolios composed of a mix that

"Furthermore, it is possible to over-diversify your portfolio, which will negatively impact your returns."

includes both stocks and bonds are referred to as "balanced" portfolios. The specific balance of stocks and bonds in a given portfolio is designed to create a specific risk-reward ratio that offers the opportunity to achieve a certain rate of return on your investment in exchange for your willingness to accept a certain amount of risk. In general, the more risk you are willing to take, the greater the potential return on your investment.

So what are your options?

If you prefer uncomplicated investment scenarios, you could choose a single balanced mutual fund and invest all of your assets in the fund. However, investors with large sums of money often require strategies designed to address more complex needs, such as minimizing capital gains taxes or generating reliable income streams. Furthermore, while investing in a single mutual fund provides diversification among the basic asset classes of stocks, bonds and cash the opportunities for diversification go far beyond these basic categories. For more sophisticated investors, you generally want to also diversify among money managers so that you get the expertise from specialists as apposed to putting all your money with one company.

With stocks, investors can choose a specific style, such as focusing on large caps, mid caps or small caps. In each of these areas are stocks categorized as growth or value. Additional choices include domestic stocks and foreign stocks. Foreign stocks also offer sub-categorizations that include both developed and emerging markets. Both foreign and domestic stocks are also available in specific sectors, such as biotechnology and health care.

In addition to the variety of equity investment choices, bonds also offer opportunities for diversification. Investors can choose long-term or short-term issues. They can also select high-yield or municipal bonds. Once again, risk tolerance and personal investment requirements will largely dictate investment selection.

Concerns

With so many investments to choose from, it may seem that diversification is an easy objective to achieve, but that sentiment is only partially true. The need to make wise choices still applies to a diversified portfolio. Furthermore, it is possible to over-diversify your portfolio, which will negatively impact your returns. With that in mind, buying four large-cap mutual funds may do more harm than good.

"For those lacking time, money or interest in investing, managed accounts or portfolio management services can provide a convenient option"

Having too many investments in your portfolio doesn't allow any one of them to have much impact, and an over-diversified portfolio *(sometimes called "diworsification")* often begins to behave like an index fund. In the case of holding a few large-cap mutual funds, multiple funds bring

the additional risks of overlapping holdings as well as a variety of expenses, such as low balance fees and varying expense ratios, which could have been avoided through more careful fund selection or using a managed account.

So how do you diversify?

Investors have many tools to choose from when creating a portfolio. For those lacking time, money or interest in investing, managed accounts or portfolio management services can provide a convenient option; these services create structures for nearly every taste, style and asset allocation strategy. For those with an interest in individual securities, there are stocks and bonds to meet every need.

Conclusion

Regardless of your means or method, keep in mind that there is no generic diversification model that will meet the needs of every investor. Your personal time horizon, risk tolerance, investment goals, financial means and level of investment experience will play a large role in dictating your investment mix.

Start with an Investment Policy Statement which can help you to figure out the mix of stocks, bonds and cash that will be required to meet your needs. From there, determine exactly which investments to use in completing the mix, substituting traditional assets for alternatives as needed.

If you are too overwhelmed by the choices or simply prefer to delegate to a service please contact our offices for an appointment.

Trademarks owned by Investment Planning Counsel Inc. and licensed to its subsidiary corporations. Investment Planning Counsel is a fully integrated Wealth Management Company. Mortgage Broker services provided by IPC Save Inc. (ON Lic. #10227). Mutual Funds available through IPC Investment Corporation and IPC Securities Corporation. Securities available through IPC Securities Corporation, a member of CIPF. Insurance products available through IPC Estate Services Inc.