Understanding investment risk

Diversification – the smart way to invest

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At its core, investing in financial assets involves taking some financial risk in the pursuit of potentially higher rewards than cash alone usually provides. In this sense, risk can be helpful but it is important to understand what 'risk' really means and how diversification – spreading money between different types of investments – can be used to manage it.

Putting money to work

Current low interest rates means cash in the bank has generally paid savers very little reward in recent years. As a result, some people may wish to explore other ways of generating income, such as investing in financial assets.

Investing involves accepting a level of financial risk with the aim of generating better returns. Different types of investments (called assets or asset classes) will involve different levels of potential risk and reward.

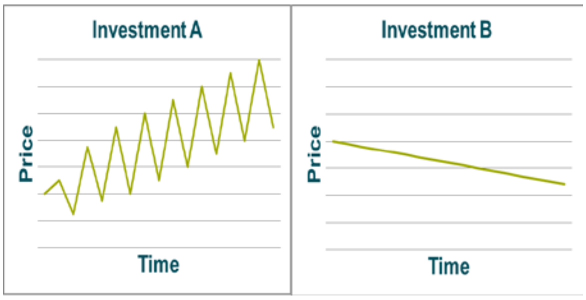
True risk

Investors often confuse 'risk' with something called 'volatility'. We believe that investment risk ultimately comes down to one thing: the chance of losing money once it is time to close an investment (once the investor has 'arrived at their destination').

Volatility, on the other hand, is a measure of how much the price of an asset moves over time. It gives a sense of 'how bumpy the road is' for an investor. However, volatility is only relevant if it is appropriate to the individual investor's time horizon.

Figure 1 illustrates two hypothetical investments. Investment A is certainly more volatile over short periods, so if you were planning to hold it for only a day, your chances of losing a significant amount are much greater than they are for Investment B.

Figure 1. Two investment scenarios



Source: M&G, illustrative purposes only.

However, as you extend your time horizon, you can see that although Investment B is less volatile (that is, it moves less over shorter time periods) it has actually proven to be a far riskier.

Diversification

So, over meaningful time periods, temporary volatility should not distract investors from their longer-term convictions, if the facts supporting those convictions have not changed. Nonetheless, volatility can still be uncomfortable to tolerate. It is important that investors without a high appetite for volatility do not overly expose their capital to a single area. The process of **diversification** is a well-established way of managing volatility.

Diversification essentially involves allocating capital (the money you wish to invest) across a range of asset classes or sectors to spread risk (ie, not "putting all your eggs in one basket"). Because different asset classes can often behave differently under different environments, this can help to smooth the overall path of returns in a diversified portfolio.

Diversification can be implemented between asset classes (eg, holding company shares for growth for the future and bonds[1] for stability of income today), and within asset classes (eg between different regions, industries or size of company).

Don't 'set it and forget it'

The process of diversification is a cornerstone of basic investment principles. However, for several reasons, the process is not necessarily as straightforward as it may sound.

In general, risk is considered to be compensation for returns, therefore investing usually involves a risk/return trade-off: assets that have the potential to deliver the highest returns are considered to be riskier than those that are expected to deliver lower returns. However, it is important to understand that no asset class has a static risk/reward profile that you can expect to be consistent at all times. Investment risk will vary with all kinds of factors – the current price, the economic backdrop, newsflow or investor sentiment.

As investors have come to understand the increasing relevance of this principle in today's uncertain market environment, they have started looking for efficient ways to best diversify their portfolio. One of the most straightforward ways of achieving this is to invest in a 'multi-asset' fund or funds.

What is a multi-asset fund?

Put simply, the term 'multi asset' usually refers to a fund that can allocate between several different asset classes across the investment landscape.

Achieving effective diversification can be complicated, which is why many investors who do not feel proficient enough themselves prefer to hand over the decision over apportioning the assets to the experts. This is where multi-asset funds are particularly useful as they are often seen as a 'one-stop shop' solution for investors wishing to take a more hands-off approach (although investors should always be sure to continue to review their circumstances against the fund's objectives).

Effective diversification involves finding the right blend of assets to keep volatility low. This should be done through identifying uncorrelated asset classes – that is assets that may react differently to each other in varying situations – so that when one holding falls in value, the likelihood is that another holding will be rising in value. Many investors will lack the resources required to monitor these behaviours across a wide enough range of asset classes to achieve effective diversification.

How do multi-asset funds help to manage risk?

Because multi-asset funds can invest in several asset classes, often across a wide universe, investors are not exposed to the market movements of just one asset class. This reduced dependence on the returns of individual assets or sectors means that the performance of multi-asset funds is typically less erratic than single-asset funds, especially equity (company share) funds.

Based on historical experience, we know that no asset will outperform through every stage of the economic cycle. Through careful portfolio diversification, multi-asset funds will try to navigate markets under different conditions, aiming to outweigh losses from allocations to underperforming assets with gains from allocations to outperforming assets. As a result of this diversification process, multi-asset funds broadly aim to deliver stable returns in 'good' times and shield investors from significant losses during 'bad' times.

However, 'multi asset' can be something of a wrapper term and not all multi-asset funds are the same. As such, investors should first define clear investment objectives and then make sure they familiarise themselves with the general goals of any fund they are reviewing to ensure that what is 'under the bonnet' meets their needs. A professional financial adviser can help individuals with this process.

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[1]A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back the original amount you invested.

We are unable to give financial advice. If you are unsure about the suitability of your investment, speak to your financial adviser