

# VIEWPOINT

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# Does diversification matter?



**When it comes to building your investment portfolio, you might have been warned about avoiding putting all your eggs in one basket. It's wise to spread your money across a range of different investments. That way, if the value of one of them falls, it should have a limited effect on the overall performance of your portfolio.**

## How to diversify your portfolio

In practical terms, diversity involves investing in different asset classes across various countries and regions.

The two main asset classes in most portfolios are shares and bonds, and these behave differently. When you invest in shares, you buy into a company's ongoing operations. The value of shares fluctuates according to the fortunes of the company, so they are riskier than bonds. Of course, the returns can be greater too.

A bond is effectively a loan to the issuer in return for a fixed interest payment. A government bond, such as a gilt, is considered among the least risky investments, as the UK government is unlikely to default, although returns can be lower.

Most portfolios will also diversify holdings across developed countries, like the UK, the US and within Europe, and regions such as emerging markets (EMs). Developed countries typically have relatively stable economies and stock markets comprising large, well-established companies. EMs on the other hand, are growing faster so they offer greater potential rewards, however, they tend to be more unpredictable so they are regarded as higher risk.

## How diversification works

During times of uncertainty, bonds usually rally as investors move their money out of shares and into safe-haven assets. When the outlook improves, shares rebound as investors switch back to taking greater risk in return for what they hope will be a higher reward.

As for geographical diversification, any number of economic or political factors can weigh on the financial markets in one country or region without necessarily spreading into others.

Assets and regions are not always uncorrelated in the short term. Most asset classes fell towards the end of 2018 due to concerns about global trade, slowing economic growth and the prospect of rising interest rates. They then rose in tandem at the start of 2019. As long as your portfolio is well diversified, it should weather market fluctuations.

*The value of your investments and any income from them can fall as well as rise and you may not get back the original amount invested.*

**Don't Put All your Eggs in One Basket**  
This idiom comes from an old proverb, most likely Spanish or Italian, and first found in print during the 17th century. It appears in Don Quixote by Miguel de Cervantes 1615 as "it is the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket."

# How inflation eats into your returns

## Food price comparison

	1989	2019
<b>White sliced loaf</b>	49p	£1.09
<b>Chicken (fresh / per kg)</b>	£1.89	£2.77
<b>Milk (per pint)</b>	28p	44p
<b>Oranges (each)</b>	17p	38p
<b>Draught lager (per pint)</b>	£1.06	£3.69

**The value of your investments can fall as well as rise, and you could get back less than you invest.**

**Understanding inflation and its impact on your portfolio is important because rising prices can reduce the value of the money you get back from your investments.**

## What is inflation?

Inflation is a term used to describe a rise in prices. In the UK, it is measured by the Consumer Prices Index including owner-occupiers' housing costs (CPIH), the Retail Prices Index (RPI) and the Consumer

Price Index (CPI). CPI the most commonly quoted measurement tracks the changes in prices of several hundred household goods and services including food, clothing and recreation. The Office for National Statistics publishes CPI figures on a monthly, quarterly and annual basis.

Prices increase for a variety of reasons, such as a rise in the cost of the raw materials used to manufacture goods, or tax cuts which encourage consumers to spend.

In the UK, inflation has drifted above the Bank of England's (BoE) target of 2% since the Brexit referendum as political uncertainty has caused sterling to weaken against other major currencies. Weaker sterling means goods imported from outside the UK become more expensive.

Most other major central banks set a similar target because a healthy level of price rises reflects a strong economy. If inflation races ahead for any reason, the banks can use interest rates to get it back under control.

## Why does inflation matter to investors?

Inflation reduces what is known as your purchasing power. In short, when prices rise, you can buy less with your money. This effect does not just impact your day-to-day spending though, it also eats into the returns generated by your investments.

Say your portfolio increased in value by 5% in a year. This is your nominal rate of return. However, prices rose by 2% during that time, consistent with the BoE's target. To determine your real rate of return, you need to subtract the inflation rate (2%) from your nominal return (5%). In this case, the value of your portfolio increased in real terms by 3%.

## Inflation proofing your portfolio

An investment portfolio should ideally be designed to deliver returns that beat inflation over the long term (five to ten years), even if it does not achieve this aim consistently throughout the whole investment period.

Bonds play an important role in the diversification of risk in your portfolio, but they may underperform when prices rise because payments become worth less. Fixed interest payments received by bond investors stay the same regardless of inflation, while equity investors earn a variable return which they expect, to some degree, to reflect changes in inflation. Alternative asset classes such as commercial property and commodities might also benefit from rising prices. Conversely, with interest rates at record lows since the 2008 financial crisis, holding cash will generate negative returns.

# Investing for the next generation

In the early years this might translate into a surplus of toys or days out, but this stage eventually passes and thoughts turn towards the future transition from child to adulthood and beyond.

This longer-term perspective raises the question of how best to provide financial support through, what could be an expensive transition and inevitably this leads to a variety of issues:

- Are there particular needs which should be targeted or is it more important to have money available as and when your child needs it?
- Which investments would be appropriate?
- Is it possible to put some parental or other controls in place for when children can access the investment?
- Which are the most tax-efficient investments?

## Investing for life's key events

For today's children, the path through the early years of adulthood might cost rather more than that of their parents - and grandparents:

**Higher education** may be seen to be more important for gaining a reasonable job, but it also comes at a much higher cost. Taking into account tuition fees, accommodation and living expenses, a three-year degree is likely to cost the poorest students more than £50,000 according to a 2017 Institute of Fiscal Studies report. Before 1998, there were only grants and loans for tuition fees did not begin until 2006. Your generation may have left university with a bank overdraft, but the sum owing probably pales into insignificance compared to the five figure debts faced by today's graduates.

**Marriage** is an increasingly costly staging post for those who choose it. According to the annual wedding survey by Bridebook.co.uk the average cost of a wedding in 2018 was just over £30,000! Despite the cost, two thirds of couples questioned in the survey admitted to either going over budget or having no budget at all.

Getting on the first rung of the **property ladder** is another growing cost for the next generation. According to research by Halifax, first time buyers are having to find record deposits, with the national average exceeding £33,000. It's no surprise people are having to leave it until later to buy their first home.

Once they have the degree, the job and the home (and the mountain of debt), there's another long-term financing requirement which today's children will encounter: **retirement provision**.

## Take expert advice

Two principles that apply to many aspects of financial planning are particularly relevant when thinking about children:

1. The sooner you start the better, and the more scope there is for investments to grow (although there's still no guarantee that they will).
2. Take expert advice before making any decisions. The right investment set up in the wrong way can be worse than the wrong investment set up in the right way. DIY planning is not to be recommended, given the potential pitfalls.

## If you want to help your child progress through this financial landscape, please get in touch.

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