



Diversification

There is no free lunch. But diversification comes close in investing.

In fact, the idea of diversification as the closest thing to a “free lunch” for investors has been popularised since the 1950s¹ when a diversified portfolio was shown to have the ability to optimise returns with lower volatility in the long run².

Many studies done over the years have also shown that divergence in the performance of portfolios can be attributed to asset allocation².

Diversification: Why you should never put all your eggs in one basket

Put the right number of eggs in different baskets

While risk is inherent in investments, it does not mean that we should be taking additional risks blindly just to enhance our investment returns. Every asset class has its own risk and reward characteristics; they perform differently depending on the point of the economic cycle.

So, does this mean we should put as many asset classes as possible into one portfolio?

Definitely not so; **asset allocation is the process of constructing the optimal investment portfolio, with different asset classes and weightage, according to an individual's investment objectives and risk tolerance.**

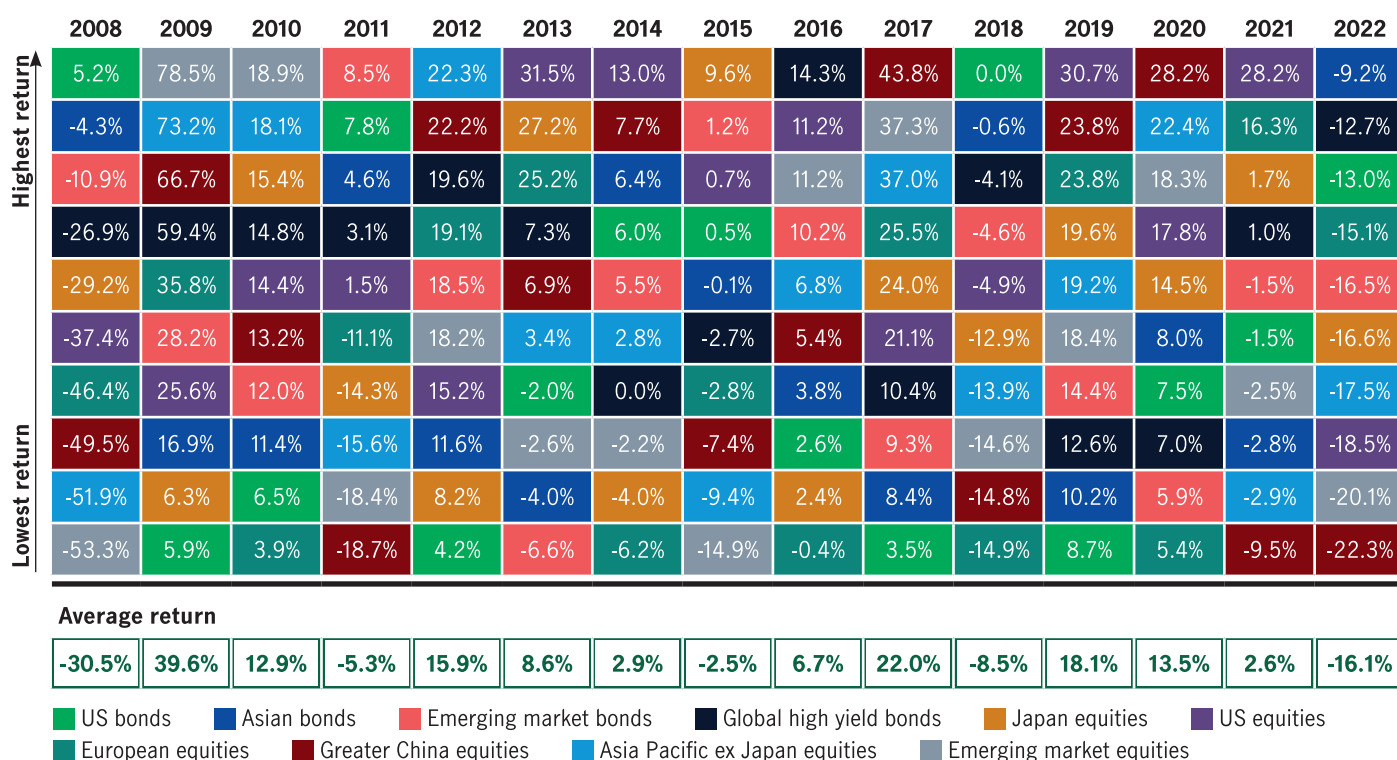
By putting different asset classes together in one portfolio, the variability of each asset class will matter less, while the overall portfolio volatility will be reduced.

The portfolio should then maximise returns for the individual's level of risk tolerance. This whole process is akin to allocating an optimal amount of eggs within different combinations of baskets.

Such, is the beauty of diversification.

Simply put, investing in a single asset is typically insufficient to meet investment objectives. But by expanding the investment universe from a single asset to different asset classes and from local to international markets, the risk of over concentration in a single asset is reduced.

Calendar year returns of different asset classes³



1 Nobel Memorial Prize in Economic Sciences recipient Harry Markowitz popularised the concept of “diversification” and “asset allocation” in 1952. (http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1990/press.html)

2 Financial Analysts Journal: “Determinants of Portfolio Performance” (May/June 1991); “Determinants of Portfolio Performance II: An Update” (Jan/Feb 1995); “The Equal Importance of Asset Allocation and Active Management”. March/April 2010.

3 Data source: Bloomberg, Manulife Investment Management, data as of 31 December 2022, total returns in US dollar. US bonds are represented by Bloomberg Barclays US Aggregate Index. Asian bonds are represented by 50% JPMorgan Asia Credit Index + 50% HSBC Asian Local Bond Index (2008 to 2012)/Markit iBoxx Asian Local Bond Index (2013 to 2022); Global high yield bonds are represented by Bloomberg Global High Yield Corporate Bond Index. Emerging market bonds are represented by JPMorgan EMBI Global Core Index. Japan equities are represented by MSCI Japan Index. US equities are represented by S&P 500 Index. European equities are represented by MSCI Europe Index. Greater China equities are represented by MSCI Golden Dragon Index. Asia Pacific ex-Japan equities are represented by MSCI Asia Pacific ex-Japan Index. Emerging market equities are represented by MSCI Emerging Markets Index. Average return refers to the calendar-year average returns of the 10 asset classes listed above. Past performance is not indicative of future performance.

5Rs: The five steps of asset allocation

So, how should one go about diversifying and allocating assets?

For a start, investors can consider the 5Rs: Risk, Return, Right Mix, Rebalancing and Review, which are the essence of asset allocation.

Risk: Know your risk tolerance

Our needs change as we go through different life stages, and it is important to understand and evaluate our unique risk tolerance. In general, young investors usually have more time on their side and can tolerate higher risk, while middle-aged investors face greater financial pressures and can tolerate only moderate risk. Senior investors, on the other hand, lack stable sources of income and should therefore focus on capital preservation.

Return: Setting expected income objectives

Before constructing the portfolio, investors should also consider their expected returns as this would largely influence the asset allocation.

Right mix: Portfolio construction

When it comes to constructing a portfolio, investors are essentially making decisions on how to allocate their capital among different asset classes, in a way that maximises the potential of investment returns, while ensuring that it fits the unique risk profile.

Key areas to consider would include: the associated investment risks, what the investment can do for you, what to invest within each asset class, and the right manager for your portfolio.

Rebalancing: Disciplined portfolio management

After a portfolio is established, should investors hold on to it without giving it much thought?

This is one common mistake to avoid; after all, markets are subject to fluctuations, and different asset classes perform differently depending on the market cycle. If left unmonitored, the initial weighting of the asset classes can change over time, resulting in a portfolio that may not be in line with the intended risk profile.

Therefore, portfolios should be rebalanced in a disciplined manner. When asset allocation weightings deviate from the initial asset mix (i.e. too high or too low), adjustments should be made. Better-performing assets may be sold to fund the purchase of underperforming assets at low price points, maintaining the original allocation weightings of the portfolio.

This risk management mechanism of “buying low, selling high” also instills discipline within investors by getting them to stay within their risk tolerance, instead of drifting away from their intended asset allocation. The asset allocation should be examined regularly, be it monthly, quarterly or annually. Deviations from the target allocation should be rebalanced to restore the target weighting.

Review: Choose investment products and managers wisely

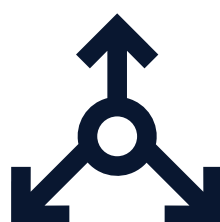
It is also important to evaluate your needs or changes in financial goals depending on the current stage in life and adjust asset allocation accordingly. One good practice is to review the past performance of various asset classes in your portfolio to determine whether they have met their investment targets.

What’s more, work with the right investment manager. Choose your manager wisely by evaluating the performance, philosophy and risk control principles.

Pathway to diversification



Asset Allocation



Diversified Portfolio



Benefits

Optimising return potential, mitigating risks

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