The Tortoise and the hare

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Gravel Road Investing

Owners of all-purpose motor vehicles often appreciate their cars most when they leave smooth city freeways for rough gravel country roads. In investment, highly diversified portfolios can provide similar reassurance.

In blue skies and open highways, flimsy city sedans might cruise along just as well as sturdier sports utility vehicles. But the real test of the vehicle occurs when the road and weather conditions deteriorate.

That's why people who travel through different terrains often invest in a SUV that can accommodate a range of environments, but without sacrificing too much in fuel economy, efficiency and performance.

Structuring an appropriate portfolio involves similar decisions. You need an allocation that can withstand a range of investment climates while being mindful of fees and taxes.

When certain sectors or stocks are performing strongly, it can be tempting to chase returns in one area. But if the underlying conditions deteriorate, you can end up like a motorist with a flat on a desert road and without a spare.

Likewise, when the market performs badly, the temptation might be to hunker down completely. But if the investment skies brighten and the roads improve, you can risk missing out on better returns elsewhere.

One common solution is to shift strategies according to the climate. But this is a tough, and potentially costly, challenge. It is the equivalent of keeping two cars in the garage when you only need one. You're paying double the insurance, double the registration and double the upkeep costs.

An alternative is to build a single diversified portfolio. That means spreading risk in a way that helps ensure your portfolio captures what global markets have to offer while reducing unnecessary risks. In any one period, some parts of the portfolio will do well. Others will do poorly. You can't predict which. But that is the point of diversification.

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Now, it is important to remember that you can never completely remove risk in any investment. Even a well-diversified portfolio is not bulletproof. We saw that in 2008-09 when there were broad losses in markets.

But you can still work to minimise risks you don't need to take. These include exposing your portfolio unduly to the influences of individual stocks or sectors or countries or relying on the luck of the draw.

An example is those people who made big bets on mining stocks in recent years or on technology stocks in the late 1990s. These concentrated bets might pay off for a little while, but it is hard to build a consistent strategy out of them. And those fads aren't free. It's hard to get your timing right and it can be costly if you're buying and selling in a hurry.

By contrast, owning a diversified portfolio is like having an all-weather, all-roads, fuel-efficient vehicle in your garage. This way you're smoothing out some of the bumps in the road and taking out the guesswork.

Because you can never be sure which markets will outperform from year to year, diversification increases the reliability of the outcomes and helps you capture what the global markets have to offer.

Add discipline and efficient implementation to the mix and you get a structured solution that is both low-cost and tax-efficient.

Just as expert engineers can design fuel-efficient vehicles for all conditions, astute financial advisors know how to construct globally diversified portfolios to help you capture what the markets offer in an efficient way while reducing the influence of random forces.

There will be rough roads ahead, for sure. But with the right investment vehicle, the ride will be a more comfortable one.

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Neither asset allocation nor diversification assures a profit or protects against a loss in declining financial markets. Currency fluctuations may increase or decrease the returns of any investment.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

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The prices of real assets (for example, precious metals) tend to fluctuate widely and unpredictably, and have historically experienced periods of flat or declining prices. Prices are affected by global supply and demand, investors' expectations with respect to the rate of inflation, currency exchange rates, interest rates, investment and trading activities of hedge funds and commodity funds, and global or regional political, economic or financial events and situations.

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The initial interest rate on an inflation-linked security may be lower than that of a fixed rate security of the same maturity because investors expect to receive additional income due to future increases in CPI. However, there can be no assurance that these increases in CPI will occur.

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