



BALANCED INVESTMENT STRATEGIES

FINANCE ♦ BALANCE ♦ LIFE

Investor Education Series

Diversification

Balanced Investment Strategies

ABN: 33 070 860 776

AFSL: 314 365

Postal Address: PO Box 1251, Palm Beach QLD 4221

Phone: (07) 5598 3800

Fax: (07) 5598 3711

Email: info@cosgroveco.com.au

Dealing With Avoidable Risks

Investing without diversifying is like going outside without an umbrella. If you are prepared only for sunny days, you expose yourself to unnecessary risk.

In the world of investment, avoidable risks include holding too few securities, betting on countries or industries, following market predictions and speculating.

Diversification reduces your exposure to those random and unpredictable forces that can wash away your returns, while making sure you are capturing risks that deliver a reliable reward.

By spreading your investments across different types of assets – whether it be stocks, asset classes or countries – you can create a portfolio built for all climates. This is because as one asset class is performing poorly, another may be doing well.

This is not to say you won't see a little rain from time to time. But diversification lessens your chances of getting drenched.

Volatility Matters

Put another way, diversification is about reducing the volatility of your returns. Why does this matter?

The table below compares two portfolios, both starting with \$100,000. After two years, Portfolio 1 has lost a quarter of its value to \$75,000, while Portfolio 2 is down by only \$1,000. Yet both have the same average return of 0%. The explanation is that Portfolio 1 is much more volatile.

It surges in value by 50% in the first year to easily outstrip Portfolio 2's relatively modest gain of 10%. But in the second year, it falls by half, this time underperforming Portfolio 2's less painful loss of 10%. In other words, Portfolio 2's lower volatility produces a higher compound return and preserves more of its original value.

So if two portfolios have the same average return, the one with the lower volatility will always have a higher end value.

This is why reducing volatility through diversification is so important. It not only makes the ride less stressful, it can also boost your wealth.

The Impact of Volatility

Impact on a Hypothetical \$100,000 Portfolio

	<i>Year 1 Return</i>	<i>Year 2 Return</i>	<i>Average Return</i>	<i>Compound Return</i>	<i>Value at End of Year 2</i>
<i>Portfolio 1</i>	50%	-50%	0%	-13%	\$75,000
<i>Portfolio 2</i>	10%	-10%	0%	-0.5%	\$99,000

Can You See a Pattern Here?

This patchwork table shows from top to bottom the highest returning asset classes each year over a selected 10-year period. So in year 2, for example, emerging markets were the best performer. A year later, they were right down the bottom.

The lack of a pattern in the jumble of colours tells you that picking which asset classes are going to be the best and worst performers from year to year is virtually impossible.

Those who do forecast it correctly usually do so only for a year or two. This tells you their success comes down to luck. Picking which country will be the best performer is just as hard.

The good news is you don't need a crystal ball. You deal with this lack of predictability by building a diversified portfolio that is structured to deliver returns greater than the sum of its parts.

In any year, some asset classes will perform poorly; some will perform well. Your best strategy is to hold a wide mix of them and stay disciplined, so you capture the premiums when they kick in.

Year ending 31 December	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Highest Return	5.35%	26.03%	28.28%	43.31%	32.08%	55.36%	28.55%	15.87%	11.81%	32.30%	32.18%	43.87%	34.21%	25.66%	14.95%	57.43%
	-3.63%	25.33%	22.10%	41.15%	21.14%	24.82%	17.93%	14.92%	8.81%	16.79%	31.30%	22.79%	34.05%	17.05%	7.60%	40.86%
	-4.69%	21.70%	14.50%	22.84%	17.94%	18.79%	14.58%	11.29%	4.78%	16.24%	27.99%	22.17%	24.27%	16.13%	-25.42%	38.95%
	-5.58%	21.43%	13.42%	20.31%	10.88%	17.24%	12.05%	7.84%	-3.53%	13.76%	26.64%	21.67%	23.43%	10.28%	-28.18%	36.19%
	-8.00%	18.68%	11.88%	14.97%	9.90%	16.98%	8.87%	5.99%	-8.62%	11.33%	21.06%	20.26%	23.14%	6.73%	-33.45%	9.97%
	-8.81%	15.85%	10.18%	13.20%	9.55%	16.64%	6.86%	5.48%	-9.13%	11.20%	17.85%	19.59%	17.49%	3.46%	-37.21%	9.56%
	-9.01%	12.76%	7.57%	12.22%	5.62%	11.32%	6.23%	5.28%	-14.54%	8.81%	17.29%	17.08%	11.51%	-1.98%	-41.10%	6.19%
	-9.23%	12.45%	6.21%	7.81%	5.15%	5.00%	2.66%	2.32%	-24.66%	4.91%	10.26%	12.70%	7.53%	-8.15%	-41.24%	3.48%
	-10.46%	8.07%	1.25%	5.64%	3.74%	-1.22%	-14.69%	1.76%	-26.05%	3.08%	6.93%	5.79%	6.04%	-8.36%	-53.17%	1.73%
	-18.84%	-1.01%	-0.76%	-1.83%	-20.67%	-4.99%	-17.94%	-9.70%	-27.17%	-0.52%	5.59%	5.73%	3.16%	-10.59%	-55.31%	0.89%
Lowest Return																

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australian Large	-8.81%	21.43%	13.42%	13.20%	9.90%	17.24%	6.86%	11.29%	-8.62%	13.76%	27.99%	22.79%	23.43%	16.13%	-37.21%	36.19%
Australian Value	-10.46%	21.70%	22.10%	22.84%	10.88%	18.79%	8.87%	15.87%	-3.53%	11.20%	31.30%	21.67%	24.27%	10.28%	-41.24%	40.86%
Australian Small	-9.01%	12.45%	28.28%	-1.83%	3.74%	24.82%	-14.69%	1.76%	-9.13%	32.30%	26.64%	19.59%	34.21%	17.05%	-53.17%	57.43%
Global Large	-8.00%	26.03%	6.21%	41.15%	32.08%	16.64%	2.66%	-9.70%	-27.17%	-0.52%	10.26%	17.08%	11.51%	-1.98%	-25.42%	0.89%
Global Value	-3.63%	25.33%	10.18%	43.31%	21.14%	11.32%	28.55%	2.32%	-26.05%	11.33%	17.29%	20.26%	17.49%	-8.15%	-33.45%	6.19%
Global Small	-9.23%	15.85%	1.25%	14.97%	5.62%	16.98%	14.58%	7.84%	-24.66%	16.24%	17.85%	22.17%	7.53%	-10.59%	-28.18%	9.97%
Emerging Markets	-18.84%	-1.01%	-0.76%	7.81%	-20.67%	55.36%	-17.94%	5.99%	-14.54%	16.79%	21.06%	43.87%	23.14%	25.66%	-41.10%	38.95%
Property	-5.58%	12.76%	14.50%	20.31%	17.94%	-4.99%	17.93%	14.92%	11.81%	8.81%	32.18%	12.70%	34.05%	-8.36%	-55.31%	9.56%
Cash	5.35%	8.07%	7.57%	5.64%	5.15%	5.00%	6.23%	5.28%	4.78%	4.91%	5.59%	5.73%	6.04%	6.73%	7.60%	3.48%
Fixed Interest	-4.69%	18.68%	11.88%	12.22%	9.55%	-1.22%	12.05%	5.48%	8.81%	3.08%	6.93%	5.79%	3.16%	3.46%	14.95%	1.73%

Dates are the annual returns to 31 December each year. The time period is 1998 – 2007. S&P/ASX data provided by S&P/ASX. MSCI data copyright MSCI 2008, all rights reserved. UBS data reproduced with the permission of UBS Warburg Australia Ltd. All data is presented in Australian dollars.

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