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.