FINANCE UPDATES

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DIVERSIFYING YOUR SAVINGS

Reduce risk with a mix of savings and investments.

Diversification is such a commonly-used term in relation to savings and investments that it can sound like a buzzword, but the basic idea behind it is simple enough.

It's the practice of making a variety of investments in order to reduce the overall risk of your portfolio.

Let's say you put all of your savings into shares in one company. If that company is successful, you're likely to see high returns, but if it fails you risk losing everything you put in.

Now let's say you put some of your savings into a cash ISA, some into bonds, and some into shares in multiple companies.

If the first company fails, you'll make a loss on that investment – but that loss won't be nearly as significant as the first scenario, as it should be balanced by gains from your other investments.

There's no way to completely remove the risk from investing, but diversification allows you to reduce it, and achieve potentially higher returns in the long-term.

DIVERSIFYING BY ASSET CLASS

Choosing a mix of different asset classes, such as cash, fixed income and shares, is one way to diversify your savings.

More recently, however, the popularity of property investment means real estate is considered by many as a class of its own.

Other investments may make up part of an asset class mix.

Cash

Cash savings, such as bank accounts, cash ISAs, and NS&I products, have the lowest capital risk of the asset classes.

This means there's no chance of losing the money you put in, unless the bank or building society collapses – in which case, the Financial Services Compensation Scheme will cover up to £85,000 per person per bank.

However, cash does come with inflation risk, meaning the buying power of your cash will be eroded over time if the interest you earn is less than the rate of inflation.

At the time of writing, the Bank of England's base interest rate is set at 0.75%, while inflation stands at 1.7% – meaning many of the cash accounts currently available will lose money over time.

Fixed-income securities

Also known as bonds, fixed-income securities work as a loan you make to a company or government for a fixed period.

You'll get interest payments over the time you hold the security, and you should get your initial payment back in full if you bought it on the market after issue and hold it until the end of its term. In general, these are relatively low-risk investments.

Government bonds are generally considered the safest kind, although their risk level depends on the country the bond is with. UK government bonds, which are often referred to as 'gilts', are low risk, but that does mean they have relatively low returns.

Corporate bonds might carry more risk as there's a chance the company could run into financial trouble and it can no longer be able to make the agreed interest payments.

You can get some idea of the level of risk a bond has by looking at the credit rating of the country or company.

As the interest you get is fixed, there's also the risk that inflation will affect the buying power of your returns.

Property

Low interest rates and rising house prices over the past 20 years have made property an appealing investment for many.

There are different ways this could be done, including buying to let or sell on, or investing indirectly through a property fund.

Becoming a buy-to-let landlord is more demanding than other investments, and it comes with its own regulatory and tax rules.

While there is potential for significant gains with property investment, the opportunity depends on rental demand and the state of the housing market, which can vary on location.

Shares

Shares are generally seen as the highest-risk asset class, with a chance of high returns as well as significant losses. However, just how high the risk is will depend on the way you invest.

Buying a share buys you a stake in a company. You could do this directly by becoming a shareholder, which may also give you the right to vote on certain company decisions.

You can also invest in shares through a fund that pools your money with other people's investments. With this option, your fund manager will choose a selection of shares according to your preferences, meaning you don't have to do all of the work.

Given the high risk involved, the longer you keep hold of shares the better, so be prepared to keep them for at least five years.

Alternative investments

Other investments that don't fall into any of these categories might come under the label of 'alternative investments', such as collectibles, art and antiques, gold, and other commodities.

These are often harder to value than more traditional investments, so they can have unpredictable levels of risk.

In many cases, this type of investment is unregulated, leaving it open to the risk of fraud.

DIVERSIFYING WITHIN ASSET CLASSES

Within each type of asset, there are other ways of diversifying.

Investing in several different companies means you're not taking on the risk of one, and the same goes for spreading your investment over a range of sectors.

Location is another factor. Major changes in one country could have a big impact on you if all your investments are held there, and investing globally can help to spread that risk.

CHOOSING THE RIGHT MIX

The right mix of assets will vary from person to person, based on your saving goals, the timescale for them, and appetite for risk.

For example, a low-risk strategy might mean putting more money into cash and fixed-income securities, while a higher-risk one could mean you invest more in shares.

Either way, you should always include some balance so that your investments aren't all concentrated in one area and it usually makes sense to reduce your level of risk as you get closer to your goal.

AVOIDING OVER-DIVERSIFICATION

Diversification is an important part of any saving or investment strategy, and done the right way, it should produce better gains over the long-term than investments that are under-diversified. But that doesn't mean more diversification is always better.

Some kinds of risk can't be eliminated, so at a certain point, the number of investments you add to your portfolio will no longer make much of a difference to the level of risk.

Instead, over-diversifying can dilute your returns, while adding extra costs to your portfolio. If you own too many investments, these disadvantages can outweigh the benefits of diversifying.

Striking the right balance and building a portfolio that's truly diverse requires time, research and in-depth expertise, and it's always best to seek professional guidance.

Talk to us about diversifying your savings and investments.