How to reduce investment risk with portfolio diversification

Whether the market is bullish or bearish, maintaining a diversified portfolio is essential to any long-term investment strategy. A diversification strategy can help you achieve more consistent returns over time and reduce your overall investment risk.

Allocate your assets

Assets are organised into classes such as equities (shares), property, cash and fixed-interest securities including bonds. Effective asset allocation will see your investment funds split across multiple asset classes to help balance risk and potential rewards.

Invest in different industry sectors

In addition to balancing asset classes, many sharemarket experts recommend balancing share investments across different industry sectors. Typical sectors include resources (iron and gold, etc.), financials (banks), communications (telecommunications), energy (oil and gas), technology and others. By splitting your share portfolio across sectors, you can help balance the normal ups and downs these sectors may experience, and their impact on your portfolio.

Overweight or underweight

Share indexes give weightings to the various industry sectors. For example, the S&P 500 might weigh basic materials at 4.5%, technology at 16% and so on. In this example, if you assigned 10% of your investments to basic materials, you would be overweight by 5.5% for that sector compared to the index.

A research analyst or financial adviser might believe a share to be under- or overvalued, and advise an investor to be overweight or underweight on that particular share. However this can be challenging to gauge and subject to change, so you should be cautious about significant overweight or underweight investing.

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Higher risk versus lower risk companies

Higher risk companies may be defined by their propensity for share price volatility and can be profitable investments. However, many sharemarket experts recommend that these investments should only represent a limited proportion of your portfolio and be balanced with investments in companies that have the potential for slower, more stable growth and less risk of capital loss.

Blue chip companies with little or no debt and steady revenue streams tend to be considered lower risk and more likely to pay regular dividends. Depending on what type of investor you are, you may have a higher or lower tolerance for risk in your portfolio. Before investing, discuss these matters with your financial adviser or another financial services professional to help you determine what the right approach may be for you.

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