

An Investor Education Initiative

Diversification:

Diversification means spreading the risk over different asset classes and over different time periods. It means investing in a broad array of investment instruments like bonds, cash, stocks and commodities. It is crucial as it reduces the investment risk over a period of time and also captures the market gains.

It is prudent to take time to build a long term portfolio of stocks, bonds and other investments on the basis of the risk appetite, investment time horizon or financial goals.

Diversification also involves periodically reviewing the portfolio mix depending on the market conditions, risk tolerance and liquidity requirement. Maintaining your strategic asset allocation is the most important input in the long term investment success.

The goal of diversification is not to boost performance and it will not ensure gains or guarantee against losses but it can help set the appropriate level of risk for an investor's time horizon, financial goals and tolerance for portfolio volatility.

To build a diversified portfolio, an investor should look for assets whose returns have historically not moved in the same direction, and, ideally, assets whose returns move in the opposite direction as this would help in mitigating risk and reducing the negative impact.

Asset Allocation:

Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash. The process of determining which mix of assets to hold in your portfolio is a very personal one. The asset allocation that works best for you at any given point in your life will depend largely on your time horizon and your ability to tolerate risk.

Time Horizon - Your time horizon is the expected number of months, years, or decades you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on a riskier, or more volatile, investment because he or she can wait out slow economic cycles and the inevitable ups and downs of our markets. By contrast, an investor saving up for a teenager's college education would likely take on less risk because he or she has a shorter time horizon.

Risk Tolerance - Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for greater potential returns. An aggressive investor, or one with a high-risk tolerance, is more likely to risk losing money in order to get better results. A conservative investor, or one with a low-risk tolerance, tends to favor investments that will preserve his or her original investment. In the words of the famous saying, conservative investors keep a "bird in the hand," while aggressive investors seek "two in the bush."

Why Asset Allocation Is So Important

Asset allocation is important because it has major impact on whether you will meet your financial goal. If you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal. For example, if you are saving for a long-term goal, such as retirement or college, most financial experts agree that you will likely need to include at least some stock or stock mutual funds in your portfolio. On the other hand, if you include too much risk in your portfolio, the money for your goal may not be there when you need it. A portfolio heavily weighted in stock or stock mutual funds, for instance, would be inappropriate for a short-term goal, such as saving for a family's summer vacation.

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The Connection between Asset Allocation and Diversification

Diversification is a strategy that can be neatly summed up by the timeless adage "Don't put all your eggs in one basket." The strategy involves spreading your money among various investments in the hope that if one investment loses money, the other investments will more than make up for those losses.

Many investors use asset allocation as a way to diversify their investments among asset categories. But other investors deliberately do not. For example, investing entirely in stock, in the case of a twenty-five year-old investing for retirement, or investing entirely in cash equivalents, in the case of a family saving for the down payment on a house, might be reasonable asset allocation strategies under certain circumstances. But neither strategy attempts to reduce risk by holding different types of asset categories. So choosing an asset allocation model won't necessarily diversify your portfolio. Whether your portfolio is diversified will depend on how you spread the money in your portfolio among different types of investments.

Diversification within each type of investment: An important factor:

Investment in equity stocks - Avoid concentration in a single stock as this would enable to spread your risk over different stocks, also diversify the portfolio over the market capitalization and sectors depending on the investment objective, time horizon and risk appetite.

Investment in bonds- Spread your investment over bonds with varying maturities, styles and sensitivity to interest rates changes.

Investment in Mutual Fund schemes- Consider a mix of style also check whether they have consistently performed relative to their investment style and objective.

Rebalancing- Diversification alone is not enough; keep a track with periodic check-ups and rebalancing. If rebalancing is not involved then it could expose the portfolio to a risk level that would be inconsistent with the investment goal and strategy of the investor.

Rebalancing of the portfolio should not be perceived as risk mitigation, the approach of rebalancing it to reset the investment mix to bring it back to the appropriate risk level of the investor. The investor may reduce the risk by increasing the allocation to the conservative option or may add risk to get back to the target mix.

When to Consider Rebalancing- You can rebalance your portfolio based either on the calendar or on your investments. Many financial experts recommend that investors rebalance their portfolios on a regular time interval, such as every six or twelve months. The advantage of this method is that the calendar is a reminder of when you should consider rebalancing. Others recommend rebalancing only when the relative weight of an asset class increases or decreases more than a certain percentage that you've identified in advance. The advantage of this method is that your investments tell you when to rebalance. In either case, rebalancing tends to work best when done on a relatively infrequent basis.

Review of portfolio at regular intervals- Review the portfolio yourself or with the help of professional advisors based on the target set for the investment. Each investor is advised to consult his or her own tax advisors / investment consultants with respect to the specific amount of tax and other implications arising out of his or her investments.

DISCLAIMER: MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.