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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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Importance of Diversifying Your Portfolio

Diversification is one of those frequently used investment buzzwords that can be heard in several different contexts. However, no matter the situation, it essentially equals risk management through variety, that is, not putting all your eggs in one basket.

An everyday example which highlights the importance of diversification can be found in cricket. If your cricket team comprised only batsmen, the likelihood of you winning a match would be slim to none. You need bowlers and a wicketkeeper (i.e. a diversified team) to increase your chance of winning.

Economic Diversification

Diversification forms a key part of the discussion about the economic environment in Trinidad and Tobago. As you know, our local economy is heavily reliant on revenue generated from the energy sector. In 2016, revenue from petroleum was $1.7 billion, which represents a drastic drop of 92% from the 2014 revenue of $19.3 billion. One of the main contributors to this decline was the drastic fall in oil and gas prices. The price of oil started off at $98.17 in 2014, but closed 2016 at a mere $52.01; a 47% decrease.

Because of the drastic drop in oil and gas prices since 2014, the Government's current revenue from taxation, royalties on oil, and profits from state enterprises has been reduced from $57 billion in 2014 to $37 billion in 2016 that is, a $20 billion decrease or 35%.

Another major issue is the depletion of the oil and gas natural resources. Evidence suggests that if we continue extracting resources at current rates, it is estimated that by 2025-2030 the gas and oil fields will be fully depleted.

Therefore, it is essential for Trinidad and Tobago to actively pursue alternative revenue sources to achieve economic diversification in order to earn income from many different sources that are not directly related to each other. So that even if an industry/commodity is not doing well, the company can rely on other elements to keep the economy relatively healthy.

Portfolio Diversification

Diversification is not only applicable on a country level but it is also an important building block for any portfolio.

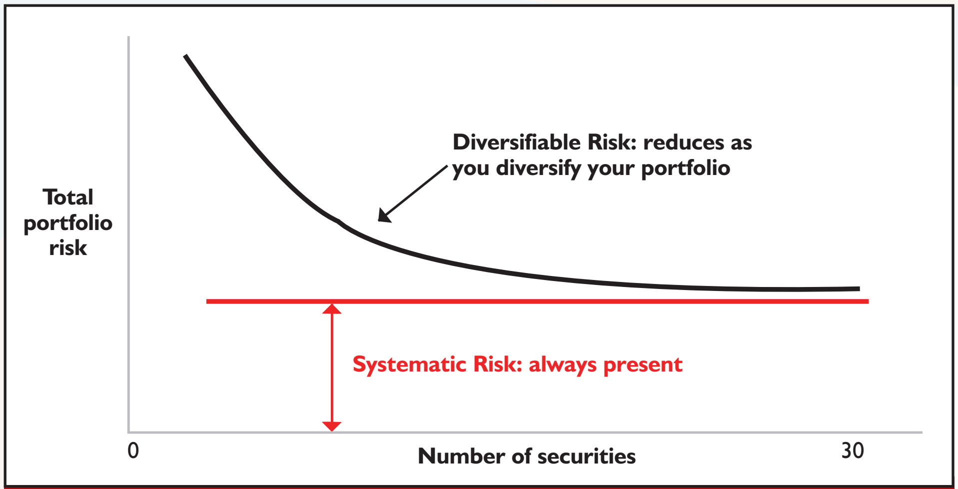
Diversification is a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. The aim of which is to maximize return by investing in different areas that would each react differently to the same event.

There are two major types of risk that face investors:

1. Systematic or market risk
2. Unsystematic or diversifiable risk.

Systematic or market risk, which is sometimes known as undiversifiable risk, is associated with every investment. Unfortunately, it cannot be eliminated or reduced by simply diversifying your portfolio as it is not specific to any particular company or industry and can be caused by political instability, war, exchange rates, interest rates or inflation.

On the other hand, unsystematic risk is specific to a company, industry, market, economy or country and can be reduced via diversification.



Source: truewealthpublishing.asia

How to Diversify Your Portfolio?

Warren Buffett is famous for saying, "Wide diversification is only required when investors do not understand what they are doing." In other words, with too much diversification, you might not lose much, but there also won't be much gain either.

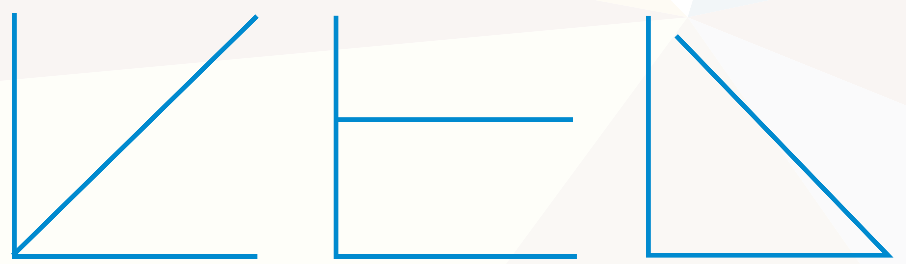
It is therefore essential to optimally diversify your portfolio as follows:

- Your overall portfolio should not be concentrated in one asset class but should include investments from the various asset classes – stocks, bonds, real estate and other alternative assets.
- You should also diversify in your various asset classes. For example, according to the modern portfolio theory, you can come close to achieving optimal diversity in your stock portfolio when it contains approximately 15 to 20 stocks. It is essential to note that you need to buy a variety of stocks from different companies, in different sectors, as well as countries, in order to fully benefit from the reduced risk provided by diversification.

It is essential to remember that no matter how diversified your portfolio is, you can never totally eliminate risk, only reduce it. Evidence strongly suggests that you can only reduce your risk to a certain point beyond which there is no further benefit from diversification.

How to determine diversified investments?

Experts do not randomly choose securities when constructing a well-diversified portfolio. One statistical technique that they use is correlation. This refers to how two variables (or investments) behave in relation to each other in the same setting.



Correlation 1.0

If one investment goes up every time another goes up, and the two go down together as well, then they have a correlation of 1.0, a perfect positive correlation.

Correlation 0.0

If the movements of the two investments show no relationship at all, they have zero correlation.

Correlation -1.0

If the two investments move in opposite directions all the time, they would have a correlation of -1.0, a perfect negative correlation.

Source: CMG Capital Management Group - Understanding Correlation & Diversification

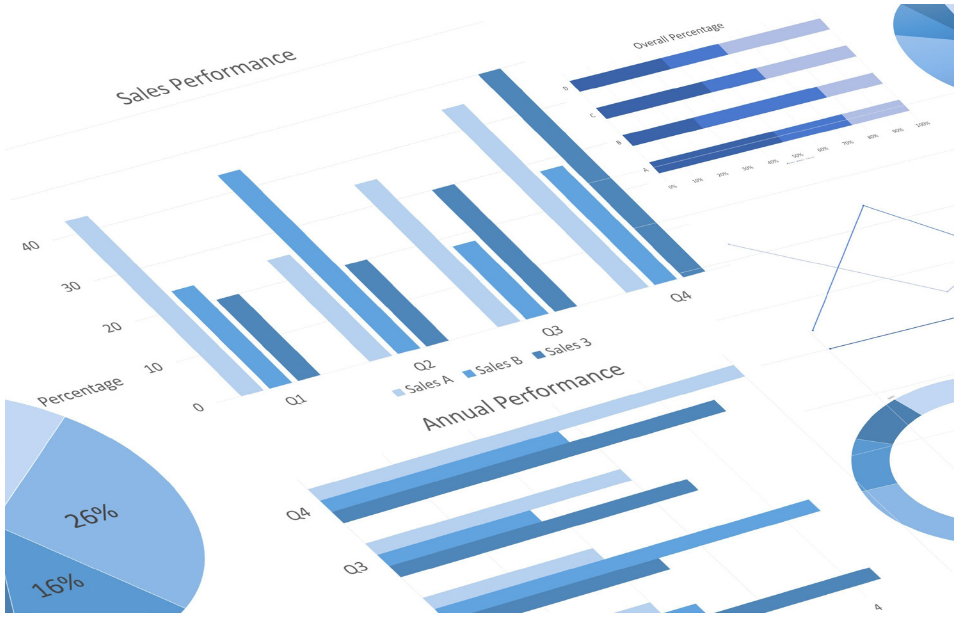
How can you use correlation to diversify your portfolio?

It is suggested that the most diversified portfolio consists of securities with the greatest negative correlation. This is because, if one investment is down, the investment in your portfolio that is negatively correlated to it will be up.

However, an investor can also achieve a diversified portfolio by investing in uncorrelated assets. This, however, carries a greater degree of risk as there will be times when both investments will be up or down.

Despite the increased risk, it is still significantly less than positively correlated investments as they will move up and down in tandem. However, even positively correlated investments will be less risky than single assets or investments that are perfectly positively correlated. However, there is no reduction in risk by combining assets that are perfectly correlated.

It is also important to remember that when the correlation between securities is calculated, historical returns are used, so there will never be complete certainty about the future.



Long-term benefit of portfolio diversification

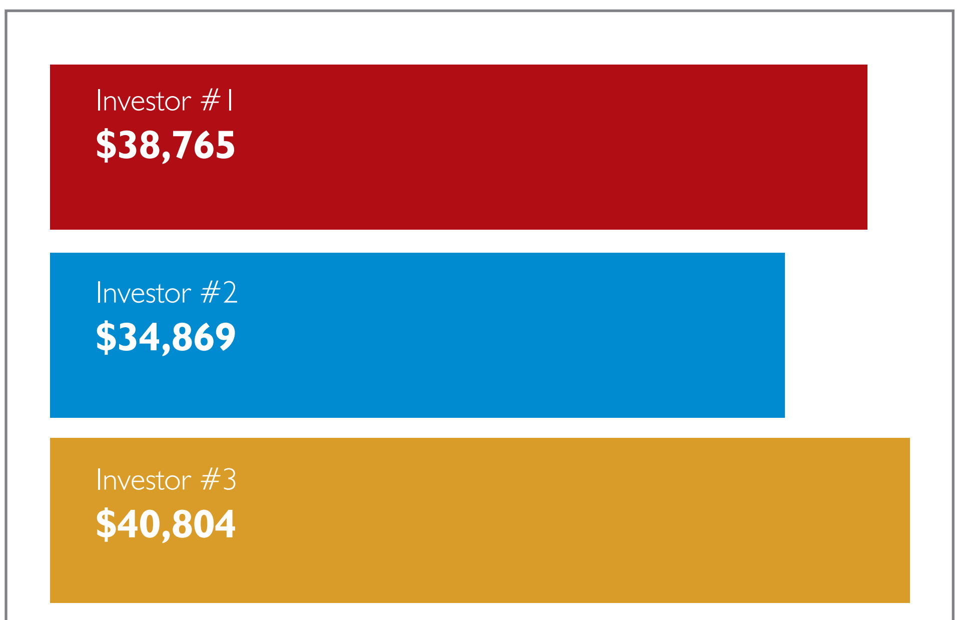
Portfolio diversification, not only helps to reduce risk but has the long-term benefit of better portfolio performance.

An example from *MFS Institutional Advisors - The Advantages of Keeping a Diversified Portfolio* highlights the long-term benefits of portfolio diversification.

Three investors each utilized different strategies to invest $1,000 each year over a 20-year period i.e. $20,000 in total.

- **Investor #1:** Chased performance – each year, investing in the previous year's best-performing market segment.
- **Investor #2:** Went for the rebound – each year, investing in the previous year's worst-performing market segment, hoping for a rebound the next year.
- **Investor #3:** Practised diversification – each year, remained invested in eight different asset classes and rebalanced the portfolio's assets each quarter so that they stayed equally distributed among the eight asset classes.

At the end of the 20-year period, the total value of each investor's total portfolio is as follows:



Source: MFS Institutional Advisors - The Advantages of Keeping A Diversified Portfolio

It is clear, that the investor who had a diversified portfolio had the greatest gains in the long term.

Investment Checklist

You diligently constructed what you consider to be your ideal investment portfolio and now, all you want it to do is to give you good returns. However, this is not where your work ends. It is essential for you to constantly monitor and review your investments in order to reap their benefits.

During your review, ask yourself the following questions to ensure you are getting the most from your portfolio:

Do you fully understand all your investments?

If you don't know how an investment actually works, then you can't know whether you truly need it and how much risk and returns it is truly contributing to your portfolio.

Can you explain exactly why you bought each investment?

It is important for you to understand the specific role each investment plays in your portfolio and how it improves your portfolio's performance. Before deciding on an investment, you should do research to understand its performance and how it enhances the tradeoff between risk and return.

Are there any investments you haven't touched since purchasing them?

Since different investments earn different returns, this can affect the asset allocation of your portfolio; therefore, it is necessary to rebalance from time to time. If you have never added or removed money from specific investments, this indicates that they are not affected by the rebalancing process and therefore not a vital part of your investment strategy.

Do you regularly add new investments to your portfolio?

Once you've created your ideal portfolio, you should not need to add new asset classes or investments on a regular basis just because they are new to market. If you do, you're more likely to end up with an unmanageable, over-diversified portfolio instead of a simpler one that more efficiently balances risk and return.

Benefits of using an Investment Advisor

A Financial or Investment Advisor will assist you in:

1. Reviewing your financial position regularly and advising you of any news (good or bad) as well as with strategies and ideas.
2. Reducing your financial stress by lightening your load. They can help you to simplify your financial options and align them to your short and long-term goals.
3. Providing expertise and knowledge and taking the time to explain the meaning of various financial concepts and how they may impact your portfolio.
4. Providing guidance on how to avoid taking unnecessary risks in order to protect the assets you've worked so hard to accumulate.

Mail: Ms. Karrian Hepburn
Chief Customer Relationship Officer
c/o UTC Advisory Services
3rd Floor, UTC Financial Centre
82 Independence Square
Port of Spain

Tel: 624-8648 Ext. 3013

Email: yourwealthmanager@ttutc.com

www.ttutc.com/advisory-services

About the Advisory Services Department

The Advisory Services Department of the Trinidad and Tobago Unit Trust Corporation was established to serve our valued clients seeking financial and investment advice and solutions from a trusted service provider. We will assist you in enhancing your personal wealth and financial well-being by providing you with financial counselling, investment advice and solutions.

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