INVESTOR NEWSLETTER

Russell Investments

DIVERSIFICATION – AN EFFECTIVE WAY TO MANAGE RISK

HELPING YOU MAKE INFORMED INVESTING DECISIONS

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Putting all your hard-earned savings into one type of investment is akin to placing all your chips on one number when you play roulette. The payout could be substantial, but you're taking a big risk. It's better to spread your money out across a variety of investments.

Diversification is essential when investing because it has the power to reduce risk while also helping smooth out returns. You wouldn't hold only one company's stock in your investment portfolio because it would be too risky. Neither should you hold only one industry, sector or asset class – or invest solely in assets from one country.

It's generally recommended to have a broad mix of geographically diverse assets, each of which will react to market events in a different manner. For example, when stocks rise, bond yields generally fall. In 2022, this relationship was fractured due to various factors, and both asset classes fell, but such behavior is rare. Since 1970, there have been only three instances in which both Canadian stocks and bonds have ended the year lower.

Not only do stocks and bonds typically move in a different manner, but stocks also tend to have bigger moves than bonds do. Bonds have often been characterized as the "ballast" to a portfolio because they can help reduce volatility and have the potential to generate steady income. Additionally, different types of stocks may move differently from others in various market environments. For example, technology stocks usually perform poorly when inflation is rising while commodity or real assets stocks benefit.

But diversification is so much more than just splitting a portfolio among asset classes. It's also important to have diversification within asset classes. Within stocks you can diversify among geographies, industries, market sectors and market capitalization while bonds can be diversified between government bonds – municipal, state and federal – or corporate – from investment grade to high yield, as well as among geographies, sectors and time to maturity. The mix you choose will depend on your financial goals, risk tolerance, amount available to invest, and time horizon.

Geographical diversification

Most investors have "home country bias," meaning the bulk of their investments are in domestic stocks or bonds. This makes intuitive sense: you are likely to be more comfortable investing in what you know. The problem is that your non-financial assets are probably also based domestically (for example, your home, vacation property, vehicle, boat, or small business) and thus are also vulnerable to the same economic and political factors that could affect your portfolio.

Even though you may have split your equity investments between value and growth stocks, small, mid and large-cap names, and across different industries, unless you have added international or emerging market stocks, your portfolio may still have concentration risk. That's because both the U.S. and Canadian stock markets are dominated by only a few players.

Geographic diversification is especially important for Canadian investors due to the highly concentrated nature of our benchmark equity index, the S&P/TSX Composite Index. The index is dominated by the banking sector, which has generally comprised at least 30% of the total weighting. Another 25-30% of the index has traditionally been in energy and materials names. Information technology, which is the sector that dominates U.S. indices, only represents 8% of our index[1] and it's comprised primarily of one name, Shopify.

Meanwhile, U.S. indices have become more concentrated in recent years. The increased use of technology since the start of the Covid pandemic has buoyed the information technology sector so that it now represents more than 28% of the S&P 500 Index[2] and 30% of the Russell 1000 Index.[3] Apple Inc., Microsoft Corp., and Amazon.com Inc. alone represent 30% of the tech-focused Nasdaq Composite Index.[4]

[1] As of June 30, 2023. Source: https://www.spglobal.com/spdji/en/indices/equity/sp-tsx-composite-index/#overview

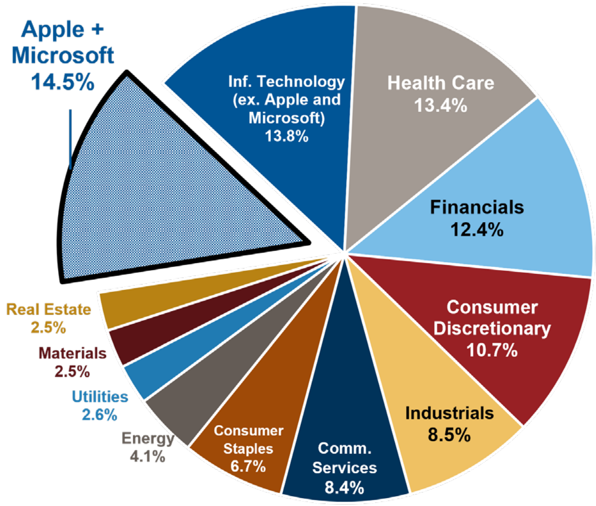
[2] As of June 30, 2023. Source: https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview

[3] As of June 30, 2023. Source: https://www.ftserussell.com/products/indices/russell-us

[3] As of June 30, 2023. Source: https://indexes.nasdaqomx.com/docs/FS_COMP.pdf

U.S. stock market has become more concentrated

S&P 500 Index – Sector weights



Source: Morningstar, Russell Investments and S&P. As of 6/30/2023. Sector returns based on S&P sector indexes.

European indices, such as London's FTSE 100 or Germany's Dax Index, are less lopsided, with consumer and financial stocks each representing around one-fifth of the total weighting. Financial names are only marginally represented in Japan's Nikkei 225 Index, and the weighting to energy names is less than 1%. The biggest weightings in this index are to consumer discretionary and industrials, mainly automakers.

The importance of geographic diversification isn't just because of the concentration issue in domestic indexes. Many different economic factors – economic growth, interest rates, currency, political events and so on – can influence which region leads in performance. Additionally, globalization and democratic trends may favor emerging economies, so it may be a wise strategy to ensure you have exposure to regions outside of North America and Europe.

Industry or sectoral diversification

Buying stocks or bonds of companies in different industries provides another element of diversification. As noted earlier, different industries react to market or economic events in different ways. Utility stocks, for example, are generally invulnerable to rising inflation, while consumer staples are more likely to do well in recessionary environments than banks are.

Company size

Generally, the larger the company, the more established it is. That makes larger-cap companies traditionally less risky than smaller ones, but they're also unlikely to be growing rapidly. Small-cap stocks usually have higher risks and higher returns because they are often from companies that are expanding and are either in new industries or innovation.

Growth and Value

Companies that are rapidly growing their revenue, profits and cash flow are called growth companies. They tend to be in newer industries – such as technology or health care – and have higher valuations compared to their earnings or book value than the broader market. Value companies are those that are growing more slowly. They tend to be more established firms or companies in certain industries, such as utilities or financials. While their growth is slower, they also have lower valuations than the overall market.

Bond diversification

Bonds are generally classified by credit risk and interest rate risk. Government bonds are considered to have the least credit risk (or risk of default), while bonds issued by emerging market governments or companies with below investment grade credit have a much higher risk of default.

Bonds with longer maturities, such as 30-year bonds, are considered to have the highest interest rate risk because no one can forecast the direction of interest rates that far in the future. In contrast, short-term bonds with maturities of a few years or less are considered to have the least amount of interest rate risk.

Alternative Asset Classes

Then there are asset classes that do not fit neatly into the stock or bond categories. Real estate, infrastructure, and commodities all have different characteristics than either stocks or bonds, and sometimes have characteristics of both stocks and bonds. Having some exposure to these asset classes can help diversify both the risk and return of your portfolio.

Finally, let's look at what each of the asset classes discussed can add to your portfolio:

- **Stocks can add long-term growth potential but can be volatile**
- **Bonds can provide income and are typically less volatile than stocks.**
- **Real estate, infrastructure and commodities can help protect your portfolio against inflation.**
- **Cash provides stability when markets are turbulent**

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