Spotlight Why diversify?

YOU MAY HAVE HEARD about the importance of diversifying your investments – or not putting all your eggs in one basket – but you may not be entirely convinced that this is the best approach to growing your wealth. In this Spotlight, we make the case for diversification and explain why it's the recommended approach to building and preserving wealth over time.

There are two sides to every coin

Return potential is clearly an important consideration when investing, but it's only one side of the coin. The other side of the investment equation is risk. Ignoring it by solely focusing on returns would be like choosing to hang glide to work rather than take the bus – either way will get you to your destination, but one carries significantly more risk.

In order to create a true comparable when analyzing returns between any two investments, you need to consider the underlying risk over time. You can do this by looking at returns on a risk-adjusted basis. In other words, the return a portfolio generates for each unit of risk it assumes.

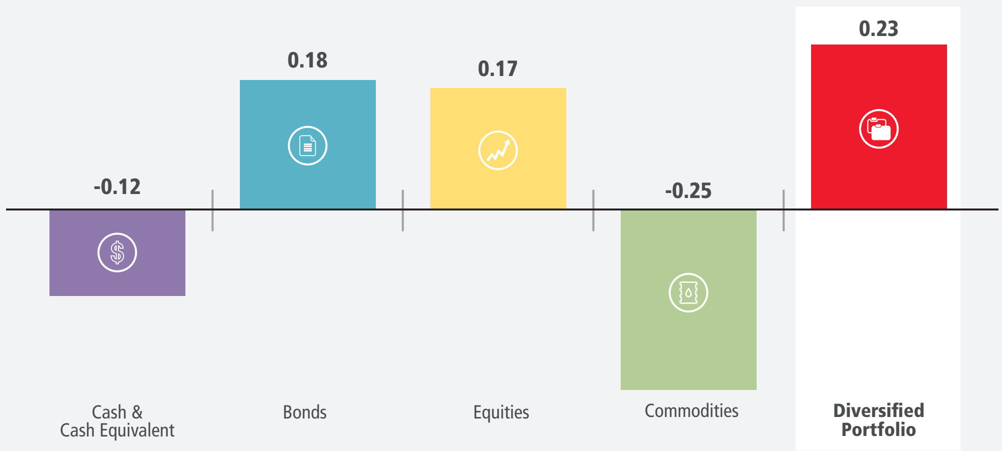
It's the same principle that applies to how people performing similar functions can receive different pay based on the specific risks of their job. A window cleaner, for example, washing windows at street level will generally earn much less than a window cleaner washing the windows of a skyscraper.

The chart below illustrates returns on a risk-adjusted basis for various asset classes, including a hypothetical diversified portfolio. You'll notice that when compared on this even playing field, diversification can be a powerful tool over time.

DID YOU KNOW?

One method of calculating risk-adjusted returns is known as the "Sharpe Ratio". It measures how much additional return an investment earns for the extra risk assumed. Generally, the higher the value of the Sharpe ratio the more attractive the risk-adjusted return.

RISK-ADJUSTED RETURNS 10-year Annualized Sharpe Ratio



Source: Morningstar – For the period January 1, 2006 to December 31, 2016. Priced in Canadian currency, unless otherwise indicated. Assumes reinvestment of all income and no transaction costs, fees or taxes. This information is for illustrative purposes only and does not reflect the actual results, future returns or future value of a mutual fund or any other actual investment. Indices are not managed and it is not possible to invest directly in an index. The asset classes are represented by the following indices and the diversified portfolio is hypothetical in nature. Cash & Cash Equivalents: FTSE TMX Canada Treasury Bill 91 day Index. Bonds: FTSE TMX Canada Universe Bond Index. Equities: S&P/TSX Composite Total Return Index. Commodities: Bloomberg Commodity Total Return Index (USD). Diversified Portfolio: Cash, FTSE TMX Canada Treasury Bill 91 day Index – 10%; Bonds, FTSE TMX Canada Universe Bond Index – 30%; International Stocks, MSCI World ex USA Index (USD) – 20%; U.S. Stocks, S&P 500 Total Return Index (USD) – 20%; Canadian Stocks, S&P/TSX Composite Total Return Index – 20%.

What's hot can quickly become what's not

Concentrating your investments in the hottest asset class of the year can be tempting – but is it wise? Historically no single asset class is consistently a top performer, with the best and worst performers changing from one year to the next as the chart below shows.

Calendar year returns (in Canadian dollars)

%	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
HIGHEST	18.6%	31.1%	75.1%	38.5%	9.7%	16.0%	48.1%	23.9%	21.6%	35.4%
	9.8%	6.4%	52.0%	20.2%	8.3%	15.3%	41.3%	14.4%	19.5%	21.1%
	3.7%	-16.1% Balanced Portfolio	35.1%	17.6%	4.6%	13.8%	31.6%	11.2% Balanced Portfolio	16.2%	17.1%
	2.3% Balanced Portfolio	-17.2%	15.9% Balanced Portfolio	13.0%	0.4% Balanced Portfolio	13.4%	13.3% Balanced Portfolio	10.6%	14.6%	8.2% Balanced Portfolio
	2.0%	-21.2%	12.5%	10.1% Balanced Portfolio	-1.8%	7.9% Balanced Portfolio	13.0%	9.7%	4.4% Balanced Portfolio	8.1%
	-5.3%	-28.8%	8.0%	9.1%	-8.7%	7.2%	7.8%	8.8%	3.5%	7.7%
	-7.2%	-33.0%	7.4%	6.7%	-9.6%	3.6%	4.3%	7.0%	2.4%	1.7%
	-10.5%	-41.4%	5.4%	2.6%	-14.2%	2.5%	3.9%	4.1%	-8.3%	-1.5%
LOWEST	-16.5%	-46.6%	-9.2%	0.0%	-16.2%	2.0%	-1.2%	-0.1%	-13.8%	-2.0%

PUT DIVERSIFICATION TO WORK

ASSET CLASS	INDEX
Canadian Small Cap	BMO Small Cap Index
U.S. Equities	S&P 500 Index
Canadian Equities	S&P/TSX Composite Total Return Index
Canadian Bonds	FTSE TMX Canada Universe Bond Index
International Equities	MSCI EAFE Index
Emerging Markets	MSCI Emerging Markets Free Index
U.S. Small Cap	Russell 2000 Index
Global Bonds	Barclays Global Aggregate Bond Index
Balanced Portfolio	40% FTSE TMX Canada Universe Bond Index, 30% S&P/TSX Composite Total Return Index, 30% MSCI World Index

Source: Morningstar. Priced in Canadian currency, as at December 31, 2016. Assumes reinvestment of all income and no transaction costs or taxes. Annual returns compounded monthly. The asset classes are represented by their indicated indices and the balanced portfolio is hypothetical in nature. This information is for illustrative purposes only. It is not possible to invest directly in an index.

It can help keep you on the straight and narrow

If you think about investing as you would your diet, diversification is similar to eating from all the food groups, providing your body with all the nutrients it needs to stay healthy. As your body changes over time, a different combination of nutrients may be needed to maintain optimal health. Likewise with investing, the asset mix that was originally created for an investor inevitably changes as a result of changing circumstances. Periodically revisiting your asset allocation ensures that your risk and return objectives remain aligned.

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Some final thoughts

A well diversified and properly rebalanced portfolio can help protect on the downside while potentially generating higher returns on a risk-adjusted basis. While that might not be a home run per se, historically it's been a proven winner. Contact a Scotiabank advisor today to determine the Scotiabank Portfolio solution that best meets your needs.

CONTACT US

Scotia Portfolio Solutions offer diversified mix of investments in the convenience of a single solution. They are professionally managed to deliver optimal risk-adjusted returns and can meet a variety of financial objectives.

Speak with a Scotiabank advisor for more information.

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