What Self-Directed Investors Should Know: Part 1

Description

It can be exciting and rewarding to build and manage your own portfolio. However, self-directed investors should keep diversification in mind, so their portfolio risk can be reduced.

Asset diversification

A portfolio can be diversified by asset classes, such as cash, bonds, stocks, and real estate. By being diversified, you won't have all your eggs in one basket. So, if one asset class underperforms, the hope is that the other asset classes won't be affected and will do just fine.

Stock diversification

A stock portfolio can be diversified by the types of companies it holds. For example, **PepsiCo, Inc.** (NYSE:PEP) is in the consumer staples sector. Pepsi's earnings power tends to be stable no matter how the economy is doing. In the last recessions that occurred in 2001 and 2008, Pepsi's earnings per share actually rose. Although it currently only yields 2.8%, it should announce a dividend hike this year, as it has for the last 44 years.

With earnings expected to grow about 6-8% in the medium term, Pepsi could increase its dividend by 5-7%, depending on if it wants to expand its payout ratio of about 62% or not.

Other industries whose companies tend to generate stable cash flows include telecoms, utilities, and real estate investment trusts (REITs). So, their dividends and share price should be more stable than industries such as the mining and energy sectors.

By buying the leaders in each of the stable industries, you can build a diversified portfolio of solid dividend stocks that have little correlation to each other. In doing so, you can lower your risk.

BCE Inc. (TSX:BCE)(NYSE:BCE) is a leading telecom with a 4.8% yield, and **Fortis Inc.** (TSX:FTS) is a stable, regulated utility with a 3.8% yield. Canada's largest REIT is **RioCan Real Estate Investment Trust** (TSX:REI.UN) that yields 5.4%. However, you can gain more diversification from **iShares S&P TSX Capped REIT Index Fund** (TSX:XRE), a Canadian REIT exchange-traded fund (ETF).

ETF diversification

If your portfolio includes ETFs, you should know what they're exposed to and try to have as little overlap as possible. Let's say you decided to buy **iShares S&P/TSX 60 Index Fund** (TSX:XIU). It has only 1-3% exposure to utilities, healthcare, and information technology.

The next thing you might do is to look for other funds or stocks that have more exposure to those sectors.

For healthcare exposure, investors can consider **Health Care SPDR** (NYSEARCA:XLV),
iShares NASDAQ Biotechnology Index

(NASDAQ:IBB), or their top holdings. Health Care SPDR is exposed to healthcare and biotechnology equities and has US$12.6 billion of assets under management. On the other hand, iShares NASDAQ Biotechnology Index is focused on the biotechnology industry and has almost US$7.6 billion of assets under management.

These ETFs intend to replicate the performance of the related indices. So, they're diversified by nature. Health Care SPDR has 55 holdings with about 55% of its assets in its top 10 holdings, while iShares NASDAQ Biotechnology Index has 191 holdings with about 63% of its assets in its top 10 holdings.

Conclusion

Self-directed investors should aim for a diversified portfolio that has different assets and/or stocks. When in doubt, consult a professional financial advisor.

CATEGORY

1. Dividend Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:BCE (BCE Inc.)
2. TSX:BCE (BCE Inc.)
3. TSX:FTS (Fortis Inc.)
4. TSX:REI.UN (RioCan Real Estate Investment Trust)
5. TSX:XIU (iShares S&P/TSX 60 Index ETF)
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