Diversification

Possibly one of the oldest pieces of investment advice is contained in the Bible in Ecclesiastes: “Divide your investments among many places, for you do not know what risks might lie ahead”, and to this day diversification has remained one of the most fundamental aspects of investment management whether for asset managers or private investors. In constructing a portfolio it is important not only to include assets that meet the portfolios objectives but also ensure the assets are suitably diverse. A well diversified portfolio should be able to provide a return from assets whose individual returns are largely uncorrelated and will therefore not all be simultaneously affected by a piece of bad news or a changing economic situation. An investment portfolio can, therefore, be seen as the optimisation of return and risk.

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There are generally two main risks to investment portfolios: Systemic and Specific Risk. Systemic risk is the risk of an event that causes market wide losses, whereas non-systemic risk or Specific Risk, is the risk of more focussed losses affecting only certain assets or asset classes. It is this Specific Risk that portfolio diversification aims to combat, by holding a diverse range of non-correlated assets a portfolio should minimise industry and company specific risk. This decreases the volatility of the portfolio because different assets should be rising and falling at different times; smoothing out the returns of the portfolio as a whole.

A portfolio manager with a target amount of total risk is therefore able to invest in higher risk, higher reward assets within a portfolio because holding a variety of non-correlated assets has lowered the total risk. Most experts believe 15-25 individual investments are sufficient to reduce specific risk. It has also been suggested that private investors wishing to manage portfolio risk should limit the amount of investment exposure to the particular sector or industry that employs them.

Portfolio diversification is not a new idea, however, in recent years diversification has arguably become even more important. Whereas twenty years ago an investor could invest in the equity markets simply by buying the major constituents of the FTSE100 index when the market contracted, the past ten years have seen an increase in market volatility meaning that equity returns have become harder to predict, thereby requiring a greater degree of diversification in order to mitigate the risk of capital loss. This rise in volatility has also been coupled with an increased correlation across asset classes and markets.

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Although the globalisation of stock markets has brought increased asset class correlation, the increased efficiency of the global marketplace has enabled private investors and wealth managers to access (global) markets where previously the costs involved would have presented an insurmountable barrier to entry. The increase in electronic trading has facilitated entry to foreign stock exchanges thus greatly increasing the ease of investing in particular countries or regions. The last decade has also seen the continued creation of innovative products such as Exchange Traded Funds. These liquid, open-ended investment companies have enabled individuals to access non-correlated or negatively correlated asset classes such as commodities, property and smaller companies which were previously difficult to include in all but the largest portfolios. This increase in possible portfolio components has enabled wealth managers to provide broad diversification for clients irrespective of their portfolio size.