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FEATURE ARTICLE

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Diversification

I was considering investment theory recently and the generally accepted wisdom that in order to reduce risk it is appropriate to diversify.

Now diversification makes perfect sense intellectually and indeed if we look on Wikipedia it helpfully explains that: "In finance, diversification means reducing risk by investing in a variety of assets. If the asset values do not move up and down in perfect synchrony, a diversified portfolio will have less risk than the weighted average risk of its constituent assets, and often less risk than the least risky of its constituents. Therefore, any risk-averse investor will diversify to at least some extent, with more risk-averse investors diversifying more completely than less risk-averse investors."

This, as I say, makes perfect sense but the question is therefore whet is the appropriate level of diversification in order to meet your aims/objectives and risk profile?

It might be argued that in certain circumstances over diversification is inappropriate and that one does not need to, or should not, over diversify. Considering this argument I am currently reading a book on the investment philosophy of Warren Buffet and Charles Munger, who have been called by many the greatest investors of all time due to their running of Berkshire Hathaway.

Now interestingly near the beginning of the book is a list of investment lessons that the author believes we can learn from Buffet and Munger and these include, for example:

- ✓ Focusing on the characteristics of a business that will lead to high increases in earnings over the long term.
- ✓ Making sure the companies you invest in are operated by honest as well as competent executives.
- ✓ You should be aware that you may have to wait decades before an excellent company becomes cheap enough to be bought at a bargain price, if it ever does.
- ✓ If you own an excellent business it often pays to stay loyal over many decades to realise full value.

All of these are excellent words of wisdom which few would argue with but at the end of the list it states – "Avoid over-diversification".

Put simply Buffet and Munger have not become two of the richest men in the world by over-diversification.

Examples of this philosophy are provided such as, for example, the fact that in the 1950's, at the start of his career, Buffet invested 65% of his net worth in just one company, GEICO, (Government Employees Insurance Company) and in 1963 he was not afraid again to put practically "all of his eggs in one basket" investing 40% of his assets in American Express when they were the subject of a massive fraud.

I am not saying that the risks that Buffet and Munger have taken in the past are not balanced with a great deal of thought and analysis before they are made and invariably their investments have proven to be good, but it does prove the point that perhaps diversification is not always best.

So back to my question – what is an appropriate level of diversification?

Well the answer is likely to be different for different individuals and dependant on the level of risk that an investor is prepared to take, but the answer ultimately lies first in ascertaining the appropriate asset allocation for the level of risk someone is prepared to take. (Asset allocation of course in itself is based on diversification,)

The point however is that in terms of diversification once an appropriate asset allocation has been determined then it needs to be populated. There are various alternatives in order to achieve this from individual stocks, to using various collective investment schemes such as unit trusts, Oeics, Investment Trusts and Exchange Traded Funds. From an investment perspective however I believe that it is vital not to over diversify when populating an asset allocation.

An important aspect of this is the level of correlation between the investments chosen to populate a particular asset allocation and there is also the question of the level of cross holdings within a portfolio if more than one collective is selected.

To explain the importance of correlation imagine if you own two Oeics, A & B, in your portfolio and they have a correlation of +1.0. This means that if fund A increases in value, fund B will also increase in value. If fund A decreases in value, fund B will decrease in value.

Two funds with a correlation greater than zero would have a positive correlation. The closer their correlation is to +1.0, the stronger that correlation is. Two funds with a high correlation may add very little risk reduction to a properly diversified portfolio.

Of course if two funds have a correlation of -1.0, the opposite is true. If fund A goes up in value, fund B will go down in value, and vice versa. If two funds have a correlation of zero, or close to zero, it means there is little or no relationship between the two funds.

When designing a portfolio, it is therefore advantageous to combine funds that have a low or negative correlation across and indeed within asset classes.

In addition with reference to the question of cross holdings it is important to be able to identify the underlying holdings of the collective schemes within any particular portfolio in order to avoid over exposure to any particular stock or sector.

So if Fund A is a UK large cap fund it may have a significant exposure to say BP, while Fund B may be a fund investing across the UK market capitalisation spectrum but might also currently have a large exposure to BP. The actual risk that a portfolio is taking can therefore only be monitored by having accurate up to date “x-ray” analysis of the ultimate underlying investments in the portfolio and closely monitoring those.

My conclusion is that in terms of appropriate diversification the best solution for a retail investor is to speak to an IFA.

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