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February 2016

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The benefits of diversification

Over recent months, we have seen global equity markets steadily sliding as concerns about future growth prospects in China and falling commodity prices cause concern in financial markets.

The FTSE 100 Index, which measures the price of the largest 100 UK companies, is the stock market index with which we are probably most familiar because it is used extensively by the media, especially when markets are falling. This Index has fallen by more than 10% in recent months.

In this newsletter, given the timing, we thought it would be a good idea to look at the subject of diversification within investment portfolios. In addition, you may like to read our Guide to Managing Your Investment Portfolio which you can find on our website at www.breedelliott.co.uk

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Background

Diversification is a subject which we, as both investors and advisers, should have high up on our agenda when constructing, monitoring and reviewing a portfolio.

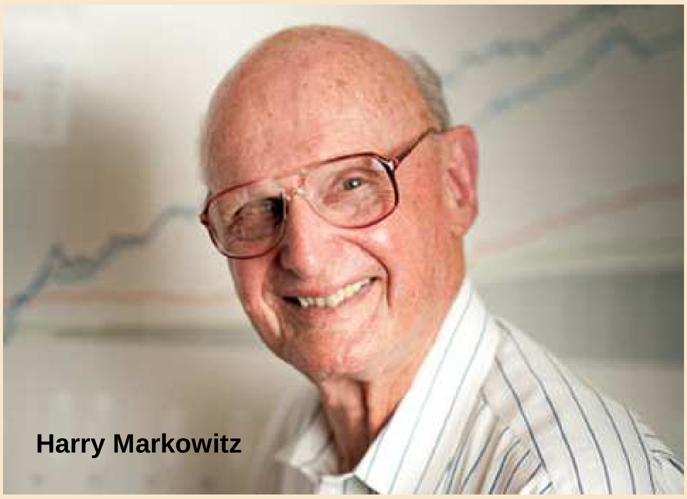
Most of us understand the principle of diversification, which is to spread assets across a number of different asset classes, sectors and geographies to deliver the best return for a given level of risk.

Combinations of assets that do this are said to be on the efficient frontier as defined by Harry Markowitz in 1952. This is the cornerstone of what is called Modern Portfolio Theory. The efficient frontier is the point where a portfolio reaches its optimal combination of assets to achieve the best return for the risk taken.

We will not dwell too long on this, only to understand that in investment theory, at least, diversification is at the heart of maximising risk returns in relation to the levels of risk taken.

Types of risk

Diversification is key to managing risk in a portfolio. So, to understand this we need to look more closely at risk, and the different types to which we can be exposed. Fundamentally there are two types of risk to address.



Harry Markowitz

Causes of systematic risk are things like inflation rates, exchange rates, political instability, war and interest rates. At this time, one of the major causes of systematic risks is the slowing growth in China, which has knock-on effects on commodity prices and on the well-being of many global emerging markets.

This type of risk is not specific to a particular company or industry, and it cannot be eliminated, or reduced through diversification. It is just a risk that we must accept.

The second type of risk is unsystematic risk and this is specific to a company, industry, market, economy or country, and it can be reduced through diversification. The most common sources of unsystematic risk are business risk and financial risk.

There are of course other factors which influence risk, most notably time. In theory the longer the investment period over which we are planning to invest, the lower the impact of periods of market volatility (such as we are seeing now) on the overall return. So, if we are investing with long-term objectives in mind, we could consider taking a higher risk than if we were investing to meet short-term objectives, all other things being equal.

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The benefits of a diversified the portfolio

A diversified portfolio will invest in a range of assets so that they will not all be affected in the same way by market events.

In simple terms, the more concentrated a portfolio, the greater the risk that, if a negative event occurs affecting markets related to the assets we are holding, they could all fall in value. If this risk has been spread by holding non correlated assets – that is assets which react in a different way to the event - the chances of significant loss are lower.

There are always exceptions to this, such as a crisis that transcends all of these normal correlations, as we saw with the 2008 global financial crisis.

An example

The benefits of diversification are perhaps best illustrated with an example.

If a portfolio were held in only one type of stock - let's say, airline stocks - and an event occurred affecting that industry, for example an indefinite strike by aircraft staff, then the share prices of all airline stocks are likely to drop, having a dramatic effect on the entire portfolio.

However, if the portfolio also held some stocks to counterbalance this risk, for example in rail company stocks, then only part of the portfolio would be affected. Indeed, the rail company stocks may increase as a result of higher demand for its services.

Of course it is possible, and indeed preferable, to diversify further than this as there are many events that would affect all transport stocks, such as an increase in oil price or extreme bad weather. This is the impact of correlation. Any event that reduced travel overall would affect the whole portfolio

In order to achieve better diversification, we would want to diversify more comprehensively, not only investing in different types of companies but also in different types of industries. The more uncorrelated the stocks are, the better.

Constructing a diversified portfolio involves a number of layers. At the headline level, we allocate our portfolio across the main asset classes, namely, equities, property, fixed interest securities and cash.

We then look in more detail at considerations such as geographical factors, market sectors and decisions on individual funds (or even individual companies if direct equities are to be included in our portfolio). Diversification is simple to understand in concept but more difficult to deliver effectively.

Monitoring and reviewing our investment portfolio

Once a portfolio is in place, it is just as important to monitor and review it on a regular basis. A core element of this review process will be to look at the asset allocation deviation; in other words, how and why a portfolio of assets currently differs from its asset allocation benchmark

Any deviation can illustrate where there are biases and unintended risks in a portfolio. Holding a range of mutual funds from different managers may seem to offer diversification but if all the managers hold 10% of their fund in Vodafone for example, then the underlying concentration risk may be higher than first thought.

Similarly, holding funds from a number of managers with the same or similar style or process may not represent a diversified portfolio as the funds may be highly correlated and, if the market moved away from this style, the portfolio could perform much worse than one which included a range of styles.

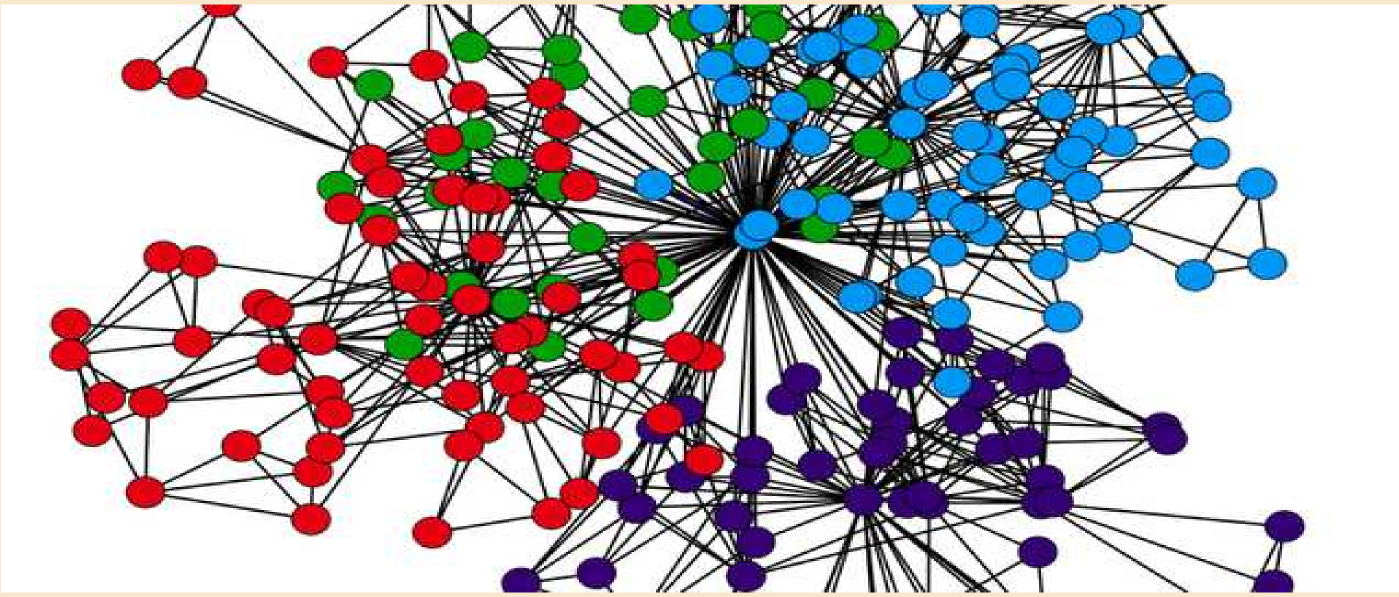
Overview

Portfolio construction is a careful balancing act. Whilst diversification should be seen as a positive, it is also not wise to over diversify as this can work against a portfolio as well. Splitting a portfolio into many small packages can incur higher transaction costs and can mean that the holdings are so small that the portfolio does not really benefit from holding the right stocks as they are in too small a quantity to influence the overall return.

In summary, the principle of diversification is generally well understood and is a vital part of portfolio planning. However, the simple message to spread our eggs across several baskets is more complex than might first appear. When looking to effectively construct and monitor different portfolios to meet different client requirements, it is vital to consider in detail the benefits of diversification and how this can best be achieved.

We are helped significantly these days by modern administration platforms, so-called ‘fund supermarkets’, which give planners and clients access to a huge number of different funds investing in different assets and using different styles. This is one good reason why it is worth reviewing older investment accounts, which might not offer the same wide fund choice.

If you would like to learn more about the subject, may we suggest that the next time you have a review meeting with your Breed Elliott financial planner, you include diversification as one of the points for discussion on your agenda.



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Market	Value at the start of 2016	Current situation	Comments
Interest Rates (BOE base rate)	0.5%	0.5% at 31.01.16	The Bank of England Base Rate remains at 0.5%.
House Prices (Nationwide)	House prices increased by 4.5% in 2015	The annual change in house prices is 4.4% at 31.01.16	UK house prices increased by 0.3% in January, with the annual house price growth broadly stable at 4.4%.
UK Share Prices (FTSE 100)	6242.30	6083.80 at the close on 31.01.16	The FTSE 100 fell by 2.54% in January amid continuing concerns about China and the falling price of oil.

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