Stock Market Review

Does diversification really pay off?

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The importance of building and maintaining a diversified portfolio of financial instruments is one of the most common views aired by many financial commentators on international media channels. These communication channels are widely available to almost everyone nowadays. Moreover, students attending courses in money management and finance inevitably also learn about the benefits of a diversification strategy.

Diversification is basically the practice of spreading one's investment portfolio among different securities to reduce overall risk. By selecting a mix of various investments, theory suggests that one may be able to limit losses and reduce the fluctuations of investment returns without sacrificing too much potential gain.

A diversified portfolio should be spread firstly across a mix of asset classes composed of shares, bonds and cash. In addition to allocating investments among these traditional asset classes and possibly others including property and fine arts, one should also aim to spread the portfolio further within each asset category. The key is to identify investments in segments of each asset category that may perform differently under diverse market conditions.

While this strategy is generally required to respect the conventional wisdom "Don't put all your eggs in one basket", Warren Buffett who is widely regarded as one of the greatest investors of all times, believes that "diversification is protection against ignorance." In fact, Warren Buffett has not followed conventional wisdom and his multi-billion dollar portfolio in his investment company Berkshire Hathaway Inc is spread among a relatively few stocks. Statistics indicate that over the past 25 years, his top five holdings on average have accounted for 73 per cent of the portfolio.

Warren Buffett prefers concentrating his investments in a limited number of companies. He argues that although many would assume that this strategy is riskier than that employed by more conventional investors, a policy of portfolio concentration may well decrease risk. In his view, a selection of a few companies will increase both the intensity with which an investor thinks about a business and the comfort-level one must feel with its economic characteristics before buying into it. Mr Buffett is of the view that once a thorough analysis is conducted and a decision is taken to invest in a company that is well-managed, as the business performs positively, the share price will eventually reflect this.

In fact, Warren Buffett explains in one of his famous books and also mentions in his popular meetings with shareholders that "wide diversification is only required when investors do not understand what they are doing". Mr Buffett and his colleagues at Berkshire Hathaway defend this view point by arguing that when investors begin to diversify among a large number of companies, they will end up selecting mediocre businesses which will not produce satisfactory returns. Some proponents of the theory to hold a concentrated portfolio rather than a diversified one sometimes refer to diversification as "deworsification" since they believe that this can lead to selecting companies in unfamiliar sectors simply for the sake of expanding the variety of the companies within their portfolio.

How does this apply to many local investors? Many of the smaller investors have focused specifically on local investments since the Malta Stock Exchange commenced operations in 1992, even though most investors had also dabbled with various investment instruments across international financial markets. In recent years an increasing number of local companies tapped the equity and bond markets, giving investors new investment opportunities. However, it is common belief that much more could have been done to deepen the local securities market and provide investors with more opportunities to choose from.

In view of the generally limited opportunities that presented themselves throughout the years, many investors continued to believe in "spreading ones investments" and not "putting all eggs in one basket". As such, very often most investors purchased securities in any new equity or bond issue simply to spread one's risk.

Unfortunately, such a strategy would have led to the situation mentioned by Warren Buffett of getting exposed to companies which may not have been well understood initially and which eventually produce disappointing returns and expose investors to undesirable levels of risk.

Hence, it is important for investors to gain a better understanding of a company, its business dynamics, opportunities/threats and some important financial indicators directly from the documentation made available at the initial offering stage or alternatively to seek assistance and guidance from trusted financial advisors.

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While this is generally regarded as an absolute necessity when investing in shares, it is almost equally important when selecting bonds. Once again, as the number of bond issuers increased in recent years, especially in 2009 and 2010, investors participated in most issues simply to obtain diversification and in some cases also with the objective of merely achieving different interest payment dates for a regular flow of income.

Investors need to look for different attributes when selecting bonds over equities and they also need to take a decision after obtaining information on the company's business dynamics, the threats that the company may encounter, the overall level of borrowings (i.e. gearing) and also the profile of the shareholders behind the project. In my opinion, these are fundamental points to consider since they determine the ability or otherwise of companies to honour their obligations even in adverse economic and/or political conditions.

A very clear distinction must also be made even in the banking sector where some investors simply viewed an investment positively since the issuer was a bank on the understanding that such an institution is in a stronger financial position and less likely to fail than other companies. Banks have different business models with varying track records and this distinction is again important before an investor decides on purchasing securities or depositing money into a fixed term account with such an institution.

In recent months, both the International Monetary Fund as well as the Governor of the Central Bank of Malta made reference to the importance of distinguishing between the different characteristics of the banks operating within Malta's financial sector.

In the January 2011 Malta report, the IMF argued that the "authorities should discourage bank business models that are overly reliant on ECB facilities for financing large investment portfolios and employ all available tools to aggressively reduce leverage in these cases".

The Central Bank has on various occasions over recent months issued reminders of this IMF warning for all to note and advised the domestic banking sector to continue to build upon the strengths of the traditional banking model. The Central Bank warned that it was not prepared to support bank models funded through the wholesale market. When referring to the 2008 international financial crisis, the Central Bank argued that following this experience, it is important for each banking institution to keep a prudent mix of dependable sources of funding, to limit the level of financial leverage and to maintain a sound balance sheet.

So, should an investor simply seek to diversify to spread one's "risks" or should a more concentrated exposure be taken after carefully considering the various investment opportunities available? This all depends on the nature and beliefs of each investor. However, in today's environment characterised by increasingly challenging and dynamic business conditions, it is becoming even more important for investors to seek professional guidance to achieve a well structured portfolio that satisfies their overall objectives whilst at the same time ensuring that they do not unknowingly expose themselves to high risk.