Achieving Investment Portfolio Diversification

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Diversification is an important consideration when constructing an investment portfolio. We all understand the importance of diversification - the old adage of "don't have all your eggs in one basket" – but what is often lost is that a fundamental principle of building a diversified portfolio is to have investments that, to some degree, behave differently in different markets or are *uncorrelated.* The reasoning for this is fairly simple: there is little benefit in having one egg in ten different baskets if each basket is just as likely to break.

Asset correlation must be considered in the context of constructing a diversified portfolio. *Correlation* is a term straight out of the financial analyst handbook, and is so often used that its meaning is sometimes lost. In essence it seeks to provide a measure of how two shares, two markets or two assets move in relation to each other. To understand this, it is important to consider how investment portfolios are constructed. Building a diversified investment portfolio necessitates an allocation to a range of different asset classes. Correlation between asset classes is an important driver of diversity within an investment portfolio. Within assets classes, diversity can also be achieved through investment style, geography and industry, to name a few.

Diversification in Today's Market

Assessing the correlation among different assets, and asset classes, has become increasingly difficult in the wake of the 2008 financial crisis. One of the big lessons from 2008 is the extent to which globalisation has created greater linkages between financial markets across different regions. Increased trade, foreign direct investment and flow of capital between markets have contributed to an increase in correlation among asset classes. We need look no further than the bursting of the U.S. housing bubble as evidence of this. Indeed, many commentators believed that crisis would be contained to American shores, and we all know how misguided that logic proved to be.

Diversifying by Company Size

So how does one serve the twin masters of correlation and diversification when constructing an investment portfolio? For the purpose of this article we will consider diversification and correlation in the context of an investor's equity portfolio (though these same principles largely hold true for other asset classes).

One approach is to invest in companies of different size. The performance of large listed companies tends, to varying degrees, to track general market conditions and economic growth within a region; therefore, one could reasonably expect that they will experience correlated performance.

It is also worth noting that investors often choose large listed companies because of their size rather than their intrinsic value, particularly as markets recover. This is often referred to as the "nobody ever got fired for choosing IBM" philosophy, which despite being a gross oversimplification does somewhat explain the mind-set that drives investor capital into larger companies.

Small- and mid-cap companies, meanwhile, by virtue of their size, are often less tied to general economic conditions. These companies may operate in newer industries or those experiencing significant technological change. Investing in such companies, however, is more challenging as there is less information available; this necessitates deploying significant resources to understand company and industry specific dynamics. Additionally, given their size these companies have a higher risk profile. The benefit is that these companies often tend to perform differently than their larger counterparts, reducing investment correlation and enhancing diversification.

Diversifying by Investment Style

Investment style refers to the approach used to invest capital. Common styles include *Growth* and *Value*. Growth investors seek out companies with above average forecasted earnings growth, irrespective of a company's share price. Value investors, meanwhile, seek to identify companies that are under-valued using common metrics, including price/earnings ratios, book values and enterprise multiples. Historically, growth and value stocks have demonstrated low correlation with each other, with respect to both performance and volatility. There are countless other investment styles deployed, each with an ability to increase portfolio diversity.

Diversifying by Geography

Despite the increase in globalisation discussed earlier, there is merit in geographic diversity. For instance, emerging markets typically generate growth rates that far exceed those of their developed counterparts, given the significant economic expansion commensurate with their stage of economic evolution. Of course, this is often achieved with a greater level of volatility than typically experienced in developed markets. Geographic diversification should not only be considered in the context of developed vs. emerging markets, since developed markets often display differing levels of economic growth as well. A comparison of how the US and Europe have separately emerged from the financial crisis, highlights this point.

Diversification in Practice – Active v Passive

Implementing a diversified approach is not without its challenges. Achieving the benefits of a diversified and uncorrelated investment portfolio must not be done to the detriment of achieving attractive risk adjusted returns. The debate on how this is best accomplished often revolves around the merits of using an active investment approach, as deployed by fund managers, or a more a passive approach.

The term passive investing is typically used to describe index trackers such as Exchange Trade Funds (ETFs) that track or follow a market index such as the S&P 500, ISEQ or FTSE. The benefit of ETFs is that they provide a low cost option to gaining equity market exposure with the knowledge that an investor will get the average return of the market. The market for passive investments has exploded in recent years – in the US in 2004 there were approximately 150 ETFs; by 2014 there were c. 1,500. This growth has facilitated the creation of ETFs that to do more than simply follow an index. Active ETFs will have a set of clearly defined rules aimed at following a particular strategy to select companies using factors such as size, dividend yield, growth, volatility, and sustainability.

Market participants are divided on the merits of active vs. passive investing. Proponents of passive investing often cite research that claims active managers perform in accordance with chance. That is, some active managers beat the index and some don't, but no more than if you had a random selection. What this fails to acknowledge is that no one invests in the broad sample of active managers used in such studies.

Even the most strident of passive investing advocates are willing to concede that some active managers have been able to consistently deliver risk adjusted returns that exceed their index benchmark, with the general consensus being that active managers are particularly able to outperform under more challenging market conditions. We all feel the pressure to sell when markets are volatile - this is human nature. If an investor believes that an active manager can navigate these challenging markets skilfully, then the investor is more likely to resist the temptation to sell and not realise losses at the bottom of the market.

Some equity investment styles may be more suited to passive investing. Data appears to support the fact that it is more difficult for active managers to add value where they are investing in larger and more liquid companies. Here, the broad availability of information means the ability for managers to identify value and out-perform an index is less obvious.

Selecting Active Managers

Optimum portfolio construction involves selecting a small group of active managers using a range of criteria, including institutional strength, portfolio management team, strategy, consistency of approach, not to mention the ability to consistently outperform an index representative of the strategy being followed. Investors also benefit from the expertise and resources deployed across a range of investment strategies, which is not possible to replicate through passive investing.

By working to identify leading active managers in their respective asset classes and investment styles, well diversified and robust investment portfolios can be designed to stand the test of time. More importantly, it is the framework of selecting and blending these managers together to reduce correlation among various investment vehicles which ultimately delivers the returns that investors are seeking to achieve.