CB financial limited

PORTFOLIO DIVERSIFICATION IS THE KEY

Portfolio diversification is truly the only investment strategy that helps mitigate the unpredictability of markets for investors. It has the key benefit of reducing portfolio loss and volatility, and has key importance during times of uncertainty.

Modern portfolio theory, for which Harry Markowitz was jointly awarded the Nobel Prize in 1990, provides the academic bedrock for diversifying portfolios. Simply stated, by combining assets that are not perfectly correlated, the risks embedded in a portfolio are lowered and higher risk-adjusted returns can be achieved. The lower the correlation between assets, the greater the reduction in risk that can be derived. Consider the situation in which an investor has an exposure to just one asset class, such as to UK Equities. The fortunes of this investor will rise and fall completely with that for UK Equities. But if this investor diversifies to also hold UK gilts, some of the risks embedded in this portfolio can be removed without necessarily impacting on returns. As one asset class performs strongly, the other may not.

UK Equities have a higher return and risk profile than UK gilts as the return risk profile of a portfolio of assets is greater than the average of the individual assets. This is the diversification benefit explained by modern portfolio theory. Diversification away from equities reduces risk while still providing attractive returns.

A logical extension of the two asset class example is to diversify further, to include exposure to additional asset classes. Economists and financial academics refer to the 'Market Portfolio' as the combination of all assets classes that generates the highest risk-adjusted returns. This portfolio is massively diversified and continually changing, and for this reason it is difficult to own in practice. Nevertheless, the market portfolio provides a useful guideline for the reduction of risk: to diversify as much as possible among uncorrelated assets. This diversification should not be restricted to one country but should include all asset classes globally.

Diversification

The key to understanding the benefits of global diversification it is useful to separate the risk of investments into two broad types, namely 'security-specific risks' and 'market risks'. Security-specific risks result from factors specific to the security, such as management skill at a corporation. Security-specific risks can be almost eliminated by gaining an exposure to a whole asset class.

Market risk results from factors that impact on groups of securities or a whole asset class, such as interest rates or macroeconomic factors like the business cycle.

By diversifying between asset classes we can reduce market risk and because of different economic factors between countries, global diversification can reduce these risks even further.

The benefits of global diversification are illustrated in figure 1, which considers four portfolios each with increasing levels of diversification. Even when diversifying within the UK, investors are able to achieve a significant reduction in risk. Portfolio 4 has exposure to global equities and bonds and includes alternative asset classes and this diversification results in a 60 per cent reduction in volatility, 80 per cent reduction in the maximum loss, as well as a slight improvement in portfolio returns, so delivering the best of both worlds – higher returns, lower risk.

The main benefit of diversification is a reduction in risk. It is worth noting maximum losses of portfolio 4 are nearly always below those of other portfolios. This is particularly evident during the recent equity bear market of August 2000 to January 2003 when UK Equities lost 43 per cent, portfolio 2 lost 17 per cent and portfolio 4 lost just 8 per cent. Going hand-in-hand with smaller losses are shorter recovery times. It took portfolio 4 just eight months to recover from its maximum loss, while portfolio 1 almost two and a half years.

Correlations

Successful diversification depends upon combining asset classes that are not perfectly correlated. It may be thought that increasing globalisation of economies and markets would lead to increased correlations between asset classes.

However, correlations are below their peaks and so there are still substantial diversification benefits available to investors. Moreover, correlations appear to be cyclical rather than containing any upward trends, suggesting global diversification benefits will continue in the future.

With increased uncertainty surrounding equity market valuations it is interesting to examine the benefits that diversification could bring during the next UK equity bear market. Without knowing the likelihood of severity of the next equity bear market, taking the average of the largest five bear markets since 1987 suggests considerable benefits may be derived.

Figure 2 presents the returns of various asset classes during these five year markets. If we apply the average performance numbers to the portfolios combinations considered earlier we see very large reductions in risk and volatility from global diversification.

There are twin benefits that diversification can bring; a reduction in both the risk of losses and portfolio volatility. Even when diversifying domestically, significant benefits can be achieved. However, to maximise diversification benefits investors should strive for a global exposure to broad asset classes. This reduces both security specific and market risks to even lower levels. Diversification will not guarantee a profit or assure against losses during bear markets. However, it should at the very least provide considerable protection of some of the gains investors have far accumulated.

For many charities the question would be how to capture returns from such a diversified portfolio. Larger funds with segregated portfolios, depending on their managers, may now be able to deal with such a problem, but small charitable funds will need the help of unitised collective funds, and the Absolute Return sector is best to achieve this. It is interesting to note, over the last three years until September 2008, fund performance for Cautious Managed funds and the All Share Index have been 5% and 9% respectively, while Absolute Return funds have returned 18% (source: Financial Express) Figure 3 for the same period. The standard portfolio of just Bonds and Equities in the modern investment climate is not effective, only through greater diversity can improved performance be achieved. Charities will need to consider their asset classes to see if they are broad enough to deliver the performance they could achieve. Many charities still restrict themselves to 1 or 2 classes - investing in Cash and Bonds being a typical choice. Now that wider investment powers have been given to them it is up to the Trustees and the appropriate investment committee to optimise the charitable funds available.

CB Financial Limited, 163 Hucclecote Road,
Hucclecote, Gloucester, GL3 3TX
FSA number 227642
Tel: 01452 611188 Fax: 01452 611122
E-mail: cbf@i12.com
Web: www.charitybusiness.com
Registered in England No. 3719734
Registered Office: As above
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FIGURE 1: PORTFOLIO RETURNS (01/91 TO 08/07)

	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4
UK Equities	100%	45%		
UK Gilts		45%		
UK Property		10%		
Global Equities			45%	35%
Global Bonds			45%	35%
Global Property			10%	7.5%
Commodities				7.5%
Hedge Funds				7.5%
Managed Futures				7.5%
Annualised Return	9.7%	9.7%	10.1%	10.2%
Volatility	13.6%	8.5%	6.6%	5.7%

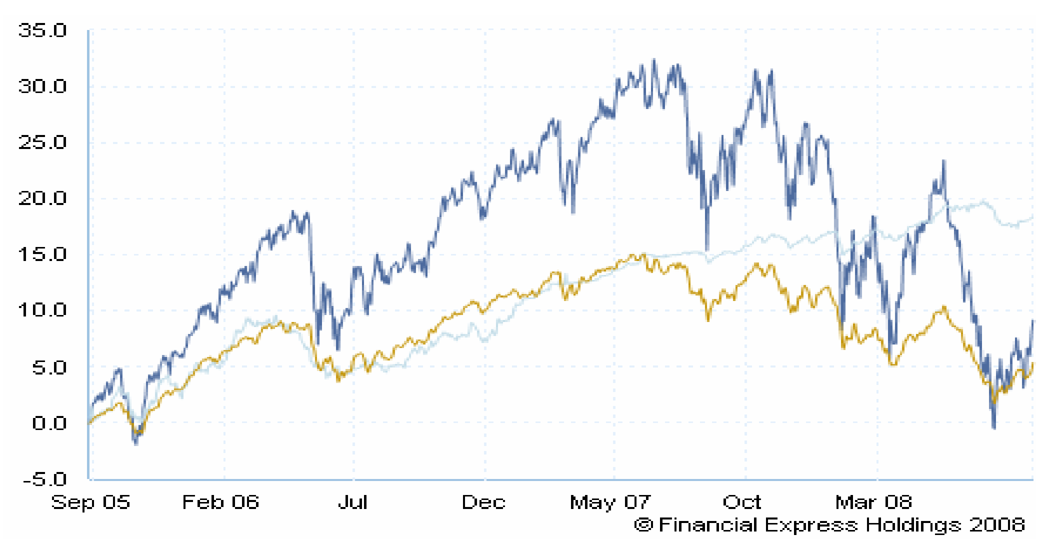
Source: Frontier Capital Management LLP

FIGURE 2: UK EQUITY BEAR MARKETS

	UK Equities	Global Equities	Global Bonds	Global Property	Hedge Funds	Managed Futures
08/00 - 03/03	-41.8%	-44%	28.1%	24.6%	6.3%	37.4%
09/87 - 11/87	-33.8%	-18.5%	5.5%	-13.3%	-8.4%	12.6%
10/07 - 07/08	-18.2%	-17.7%	4.4%	-21.5%	-4.6%	10.0%
12/89 - 09/90	-16.8%	-24.1%	5.6%	-16.1%	21.5%	31.6%
05/98 - 09/98	-15.5%	-10.9%	6.9%	-10.7%	-9.9%	10.0%
05/92 – 08/92	-15.2%	-3.9%	4.8%	-1.2%	3.4%	20.9%

Source: Frontier Capital Management LLP

FIGURE 3: THE BENEFITS OF ABSOLUTE RETURN FUNDS



Key

- FTSE All Share
- **UTY Absolute Return**
- UT Cautious Managed