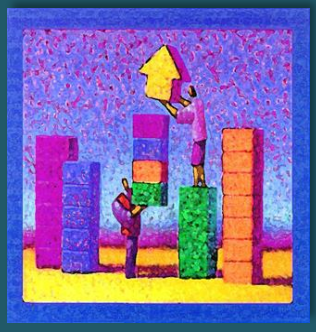

WEEKLY REPORT APRIL 2022

Private Asset Management Ltd

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DIVERSIFICATION: LOWER RISK AND (PROBABLY) HIGHER RETURNS

Two weeks ago we looked at the latest iteration of the Global Investment Returns Yearbook (GIRY) and in particular the chapter on diversification. The authors made the point that "diversification is the only free lunch in finance". They then noted that, unfortunately, the conventional wisdom is that owning only 10 – 20 stocks represents a diversified portfolio. Their research illustrated that even a 100 stock portfolio chosen randomly can still be substantially more risky than the index. The GIRY is mainly read by people working in the finance sector, academics and the odd journalist writing for the FT, Bloomberg, and NBR but frequently its insights have important lessons for retail investors: Owning a concentrated portfolio of stocks is dumb unless, of course, you look in the mirror and see Warren Buffett's face.

But lower risk is just one potential benefit of diversification – the other, equally important benefit of owning a diversified portfolio, is potentially higher returns. The authors quote a landmark study by Professor Henrik Bessembinder (previously covered in this column) which found that about 57% of all the American companies listed on the NYSE since 1926 have had lifetime buy and hold returns below that of short term US government bonds and that all the net gains in the entire US stock market are due to the outstanding returns of the best performing 4% of companies. In other words, the excess return of shares over short-term government bonds is due to the extreme outperformance of a relatively small number of stocks.

For this reason, the professors conclude that "the average individual with a concentrated portfolio is thus likely to receive lower returns than that of the overall market". The authors then made the point that "the costs of under diversification are far greater than this. A Danish study by Florentsen, Nielsson, Raahauge and Rangvid (2019) analyzed a database for 4.4 million Danish investors. They showed that investors could increase their expected return by up to 3% a year by moving from the concentrated portfolio they typically held to an index fund with the same overall risk. Investors could have achieved this by decreasing cash or short-term bond holdings and increasing the index fund holding, or via leverage, thus gaining greater exposure to the equity premium. This reinforces a key point made by Markowitz. Diversification allows us to either reduce risk for the same level of expected return or increase expected returns for the same level of risk."

Incidentally, if you thought that the Bessembinder analysis amounted to the ultimate bullet in the brain of active management think again - a major UK fund manager has used the study to market itself arguing that its conclusions support its own concentrated strategy because it can find the winning 4% of stocks. This extraordinary conclusion highlights the fact that investors should never underestimate the resourcefulness of fund managers to spin things their way.

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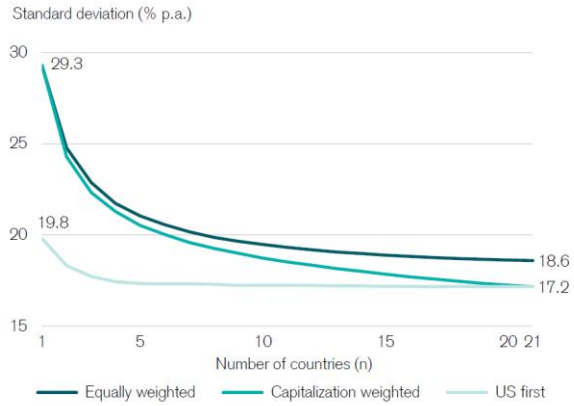
That's the "get diversified by owning lots of stocks" lesson covered but retail investors are often also handicapped by "home bias" as well whereby their portfolios are limited to the local share market. This is a particular problem for NZ investors as the NZ market represents less than 0.5% of the total global equity market and our top 10 stocks account for about 60% of the market. Many local investors regularly include Australian stocks in their portfolios but that doesn't go very far in capturing all the benefits of global diversification.

The chapter on diversification then looks at the benefits of diversifying over different countries and Figure 67 below illustrates how risk in terms of the standard deviation of returns falls dramatically as additional countries are added to a portfolio. The key line is the middle line in the graph as this represents the addition of countries weighted by their market capitalisation.

"Figure 67 is based on the 21 DMS countries with continuous histories since 1900. It shows how risk for a dollar-based investor falls as the number of countries is increased. The top, darker coloured line shows the standard deviation (SD) for portfolios that give equal weight to each country, while the second line down shows the equivalent SDs when countries are weighted by their market capitalizations. For the one-country portfolio, these two lines show the average SD of the 21 countries. For the 21- country portfolio, they show the SD of the equally weighted and capitalization weighted 21-country "World". The 2- to 20-country portfolios were selected randomly from the 21 DMS countries, without repeating countries. For these portfolios, the SDs plotted in the chart are averaged across 10,000 random iterations. Figure 67 shows that the SD of 29.3% for a typical single-country investment falls off to 18.6% for an equally weighted 21-country portfolio. For the capitalization-weighted 21- country world index, it falls to 17.2%. These 37% and 41% risk reductions are large."

Figure 67: Diversifying across countries, 1900–2021



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, DMS Database 2022, Morningstar. Not to be reproduced without express written permission of the authors.

The professors sum up by saying that investors from all countries should invest globally as it is likely to reduce risk. "However the benefits of global diversification will be much greater for smaller countries which have highly concentrated stock markets [like NZ]. Even some larger markets, such as Japan, the UK, Germany and France have limited domestic exposure to key sectors such as technology. These countries have potentially more to gain from international diversification than US investors as the US market is already very large, broad and highly diversified."

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.