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Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

THE ADVANTAGES OF AND OBSTACLES TO DIVERSIFICATION - PART II

Two weeks ago, we looked at what a sensible level of diversification looks like in respect of a retail investor's global equity portfolio and the obstacles to implementing this common-sense approach. Today the case for diversification continues as we outline the investment logic of owning, via low-cost passive and/or active funds, a widely spread portfolio of international stocks.

First up we will look at the risk aspect of diversification. You don't have to be a rocket scientist to acknowledge that owning a market capitalisation weighted portfolio of 10,000 shares is likely to be less risky than owning 20 stocks chosen on the basis of someone's view of their future returns. But diversification is not just about owning lots of shares – it's equally concerned with diversifying over many economies. In a 2019 paper, "Geographic Diversification Can Be A Lifesaver", US investment management firm Bridgewater Associates opines that geographic diversification is likely to be more important in the future than it has been in the last 40 years. This is because of the recent unusually high correlation of returns between stock markets due to globalisation. Bridgewater made the point, way back in 2019, that globalisation is under threat. Coronavirus has underlined the fragility of global supply chains and whilst that effect is hopefully transient there is a very real risk that, given the foreign policy decisions of China and Russia, the global economy will fracture into two discrete trading blocs. The authors conclude that "geographically diversified portfolios do well because they minimise drawdowns, creating a much more consistent return stream that allows faster compounding." They also look at instances where investors who concentrated their equity portfolios on single countries have seen their portfolios suffer major drawdowns. Amongst their examples is the NZ experience in 1986-1990 where losses amounted to 81%. In the same period an equal weighted portfolio of leading countries would have suffered a drawdown of just 10%.

Next, we will look at returns. One of the most important things that retail investors should understand is that, whilst picking stocks is fun and almost everybody says they can beat the market, in reality beating the average is problematic and that is an understatement. Markets are efficient most of the time - in other words individual shares, particularly the large cap names, are priced correctly so it is very difficult to find an under-priced one. This is because there are thousands of highly qualified professionals, not to mention computers, spending all day, every day, looking for cheap shares and selling expensive ones. For this reason, even the professional fund managers who benefit from various degrees of inside knowledge and information advantages, find it virtually impossible to consistently outperform low-cost passive funds. If these masters of the universe can't pick stocks, then there is not much hope for local financial advisors - unless they get lucky. Unfortunately, luck doesn't persist, but the impact of ongoing fees and turnover costs do. It's also worth noting that despite the huge increase in popularity of passive funds in the last 20 years the success of active fund managers has actually declined i.e., market efficiency has improved.

The leading database on the relative performance of fund managers is the Standard and Poors Indices Vs Active website (SPIVA). This organisation has for many years looked at the extent to which active managers underperform their relevant benchmarks. Its research "has been the de facto scorekeeper of the ongoing active versus passive debate since its first quarterly report in 2002". It calculates how well various types of managed funds perform relative to their benchmark index and their database allows them to do this for shares and bonds in the USA, Canada, Europe, Japan,

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Australia and a number of emerging markets. Readers are presented with facts rather than the propaganda and misinformation typically associated with local discussion of this topic and can thus get a feel for the actual performance of actively managed funds in general versus the relevant benchmark index. The facts are that doing as well as the “average” is not only difficult but trying to outperform is fraught with danger.

In their June 2021 report for US equities SPIVA noted that over 20 years 88% of all US domestic equity funds underperformed the index and over 5 years 72% underperformed. It’s the same story in Australia – over 10 years 80% of Australian equity generalist funds failed to beat the ASX 200 benchmark. In global equities the relative performance of Australian fund managers was even worse with 90% of international equity generalist funds underperforming the benchmark.

Besides the impact of fees and market efficiency there is another important reason why it is so difficult to beat the market - a study: “Why” Active Fund Managers Often Underperform the S&P500 - The Impact Of Size And “Skewness” makes a valuable contribution to the literature on fund manager performance relative to benchmarks. The essence of the paper is that fund managers tend to underperform because they typically own a small sample of all stocks in a market and whilst most stocks do as well or worse than the market a small minority do especially well. If you don’t own those in your portfolio you will underperform and the more narrowly defined your portfolio the less likely you will own them. Statistically speaking, in the longer-term, individual stock returns are highly asymmetrical to the right – in other words whilst some stocks do badly the maximum negative return, they can achieve is -100% but the maximum positive return can be almost unlimited e.g. over twenty years Apple shares have returned a total of 47,328%. Another paper, by Professor H. Bessembinder of Arizona State University, makes the point a different way. His conclusions are that:

Even though the average of the stock market outperforms short term government bonds most individual shares do not - 58 per cent of all US stocks listed on the US stock exchanges between 1926 and 2015 underperformed short-term government bonds over their full lifetimes.

The reason the share market outperforms bonds is due to a small number of outperforming stocks. The entire gain in the US stock market since 1926 is attributable to the outstanding performance of the best-performing 4 per cent of listed stocks.

In the paper Bessembinder explains that the reason the stock market outperforms bonds in aggregate, but the average stock underperforms is because some stocks perform extraordinarily well. In statistics this is known as positive skewness. His analysis shows that about 26,000 shares have been listed on the various US stock exchanges since 1926 and total lifetime shareholder wealth creation to December 2015 was US$32 trillion. But of the 26,000 stocks only the top 1000 performers account for all of the US$32 trillion in wealth creation. The performance of the other 96 per cent of stocks only matched that of short-term government bonds.

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

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