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Private Asset Management Ltd

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THE ADVANTAGES OF AND OBSTACLES TO DIVERSIFICATION – PART I

Arguably two of the most important rules for retired investors depending on their investment portfolios are "keep your fees low" and "diversify widely. Despite these topics being regularly rehearsed in the financial press anecdotal evidence suggests that many individuals, including some trustees of family trusts, either don't understand the issues or choose to ignore their importance. The fee topic, whilst having been the subject of more disinformation and deception than the D-Day landings, has been covered many times in this column so today we will focus on diversification. We will outline what proper diversification actually looks like, using global equities as an example, and the obstacles to implementing a highly diversified strategy. In two weeks' time that story will investigate how the distribution of individual equity gains and losses makes beating the index more a game of luck than skill and then look at the evidence as regards professional investors' efforts to outperform.

Diversification means spreading risk and with tens of thousands of shares trading on the world stock markets that logically implies deriving a big part of your exposure to global equities via a low-cost global equity ETF. These products typically own 5,000 to 10,000 shares and can form the core of your portfolio. Then if you have the funds, and can be bothered, you can complement that core holding with a bunch of low-cost active funds, further niche ETFs and maybe some direct holdings in stocks. Owning direct holdings in companies you like or think you "know" can be a lot more fun than owning an ETF but it is not worth betting the house - diversification doesn't mean just owning 20 large-cap global equities that your financial advisor thinks are under-priced.

This brings us to the obstacles to proper diversification. There are frequently three factors at play here: home bias, "expert" advice and various behavioural factors, although you could probably add the late Michael Cullen's fair dividend tax to that list for NZers. Home bias refers to the well-documented trait exhibited by some investors – often older men – of concentrating their equity portfolios just in NZ or NZ and Australia. Most often the reasons given are variations of "I know this market" or "I can keep an eye on these companies via the newspaper". Neither argument makes much sense – a local investor might think they "know" their favourite NZ shares, but stocks have been surprising investors, including their directors, for years. A2 Milk was a local stock market favourite including in its fanbase one financial advisor who reportedly had most of his clients' funds invested therein – but today it's 73% below its peak of $20.95 in August 2020. Similarly, not so long ago, the NBR comment section was particularly scathing of Pacific Edge but the shares have gone from 7 cents in March 2020 to $1.32 today. Sure, its long-term performance isn't flash but that's the point – it disappointed investors, hence the haters, then surprised just about everyone by turning things around and increasing in value almost twenty-fold. Equally, with the advent of the internet reading the newspaper about what happened the previous day doesn't offer much in the way of a comparative advantage. The illusion of

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"knowing" the local market also ignores the fact that risk is priced in the US stock and bond markets, not in NZ.

Another major obstacle to this aspect of common-sense investing can sometimes be the investment strategy promoted by the advisory firm managing the portfolio. To understand why this might be the case we need to appreciate the unique selling proposition promoted by many private banks: it is "we are experts, part of a large organisation with a big, expensive research department full of very clever people. With this resource we can pick the best stocks and outperform - in return you pay us a "reasonable "annual fee to manage your portfolio." Given this background recommending a large global equity portfolio with 9,000 shares is completely inconsistent with the firm's stock picking/outperformance overtures. Furthermore, promising to outperform then just buying an index fund could provoke some embarrassing conversations with particularly alert "high net worth" clients. Additionally, the standard method of entrenching a financial advisory service and validating your fees is to make things complicated and owning 20 "high conviction" stocks instead of one global ETF is an important part of this strategy and will inevitably require higher levels of trading each quarter with attendant costs.

The final obstacle to embracing a strategy of diversification can be various behavioural factors peculiar to the investor including overconfidence and a big ego. This type of investor has a strong self-image and frequently see themselves as winners thus the siren call of "beating the market" is a powerful selling point.

In two weeks' time we will make the case for diversification and the argument relates to both risk and return. Nobel prize winner Harry Markowitz said some time ago that "diversification is the only free lunch in investing". What he alludes to here is that, all things being equal, owning a diversified portfolio of shares improves risk adjusted returns. This is why NZ's largest equity investor, The NZ Super Fund, chooses to achieve its global equity exposure primarily through investing in a low cost passive fund.

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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