How diversified is your equity portfolio?

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There can’t be many investors today who aren’t aware of the importance of diversification. Even the simplest form of naïve diversification, which just entails spreading your equity investments over as many companies as possible, is beneficial. Other more complex forms, such as modern portfolio theory allow investment professionals to use diversification as a construct in managing portfolio risk.

For most retail investors, naïve diversification means holding as wide a universe of investments as possible. The problem is that for many investors, the universe usually only consists of ASX blue-chip shares, possibly complemented with an investment property…. which is actually a pretty small investment universe.

It is worth noting that diversification can mean much more than this. As well as spreading our capital around different blue-chip shares, other opportunities to diversify come from different markets, non-share investments, and using different strategies to select our investments.

According to the last published ASX Share Ownership study\(^1\), 90% of Australians who own direct Australian shares don’t own direct shares on overseas exchanges. The percentage of investors who own direct Australian shares who also hold a direct non-share product (REITs, LICs, Options, Listed interest rate securities, Infrastructure funds, Instalments or Warrants, Futures, ETFs, CFDs, other) is about 5%.

So… as a group, we may be diversifying amongst direct blue-chip Australian shares, but we are not directly diversifying amongst either overseas shares or non-share investments. Of course, many direct Australian share owners may invest in funds which assist with their diversification, although we often know little about the makeup of each funds specific investments and strategies. Investing in other markets and other products can help us become more diversified, but may not provide desirable tax benefits like franking credits.

Another style of diversification is strategy diversification. Essentially, this refers to the way we choose which shares to invest in, and when to invest in them. While each investor has their own chosen strategy, it is important that we follow approaches that have been thoroughly tested and have supporting academic evidence. Some investors may choose undervalued shares, some may choose growth shares, or some may choose shares because they exhibit certain properties (such as momentum, or mean reversion, reversal, etc). Others may use timing approaches like Technical Analysis to help decide when to make an investment.

Now that we have considered a few different types of diversification, it’s worth taking some time to think about how you currently choose your investments, and whether you could be more diversified. As the principles of choosing shares from different markets and non-share investments seem relatively straightforward, I will focus on strategy diversification.

Many investors use Fundamental Analysis or a form of financial ratio analysis to attempt to select shares whose intrinsic value has not yet been recognized by the market. Although traditional

Fundamental Analysis provides a solid framework to consider an individual companies’ intrinsic value, it has two limiting factors for many investors.

Firstly, it doesn’t allow practitioners the opportunity to directly apply their skills to non-share investments, and secondly, it doesn’t allow practitioners the opportunity for strategy diversification. The first factor is because many non-share investments can’t be analysed the same way as a company’s shares. Company financial ratios may not be available, or company profits and losses may not be appropriate (think about something like foreign exchange). The second factor is because in an intrinsic value framework, the principle of buying stocks whose intrinsic value is above the market value is the only principle that makes clear sense. It would be counter-intuitive to determine a market price was way above intrinsic value and then go ahead and buy it anyway. Although there are undoubtedly ways that fundamental analysis can support non-share investors, that doesn’t tend to be the way that most retail investors appear to operate.

For many investors, that’s where Technical Analysis steps in. Almost all Fundamental Analysts already practice some simple form of Technical Analysis, even if they aren’t directly aware of it. Even if the buy/sell decision is based entirely on intrinsic value, the investor still needs to decide when to execute the buy/sell decision, and thus, there is a timing component. The only exception would be if a fundamental investor executed the buy/sell decision immediately on completing the analysis. In practice, if an investor determines a buy decision is appropriate, it would be illogical to execute the decision without at least looking at the price movements of that company and the market. After all, how many fundamental investors were rushing out buying into the huge price falls sustained during the early part of the GFC? The decision to buy could have been correct from an intrinsic value point of view, but it should be reasonably clear that delaying decisions until markets stabilized was probably a sensible choice.

Technical Analysts primarily focus on past security prices and returns, attempting to identify trends in price movement. It is fairly well known that most share price series exhibit low-frequency positive autocorrelation, which form the basis of what many investors call ‘trends’. Many traditional fundamental investors were brought up to ignore technical analysis, believing it had nothing to offer. It is a source of amusement to professional technical investors that what is often termed to be the most beneficial investment anomaly for retail investors, that has defied traditional finance academics for decades, is momentum, which is purely based on past prices and returns. Indeed, the father of the Efficient Markets Hypothesis, Eugene Fama, describes momentum as ‘the premier anomaly’.

What is interesting here is that frameworks based on Technical Analysis do lend themselves to exactly the things that Fundamental Analysis did not, namely, an opportunity to apply learnt skills to non-share investments, and endless opportunities for strategy diversification. Clearly, the two frameworks are not competitive, they are complementary!

It is not my intention to promote Technical Analysis over Fundamental Analysis. Rather, it is my intention to encourage investors to try and actively look for ways to combine both frameworks. Fundamental investors can decide on which shares are appropriate for their portfolios using intrinsic

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value frameworks, then look for ways to use Technical Analysis to improve their entry and exit timing. In this way, it is possible to leverage the benefit of both frameworks.

Using this kind of approach, traditional fundamental analysts can learn to improve their timing abilities. They can then look to use these new timing skills to improve their share investment performance, to identify non-share opportunities, and to develop alternate strategies to engage with the market. This should help investors to find ways to increase their investment performance and their diversification ... and we know that diversification is the only free lunch in the markets!