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RODNEY'S RAVINGS

Is portfolio diversification the biggest marketing scam going?

EXECUTIVE SUMMARY

As an investment philosophy portfolio diversification can have lots going for it. In particular it can help investors prone to getting caught up in the latest investment craze from doing all their dough, while for people who have many years ahead to building up a retirement nest egg it is good in part because it puts the focus on regular savings and gets the nest egg further away from temptation.

But in the hands of the people who use it as a marketing tool without understanding the pitfalls inherent in mindless diversification it can become a bear trap for unwary investors. The number of retired people who have been badly burnt by having large portions of their nest eggs invested in a diversified portfolio of somewhat fringe finance companies is the most recent example of portfolio diversification being used by some individuals and investment advisors as if it was the panacea for all investors in all circumstances.

The beauty of being armed with portfolio diversification as the sharp end of a marketing campaign is that it does away with the need to be able to assess if markets are good or bad value. By contrast, the best investors in the world, including the likes of Warren Buffet, focus most on investing in things that offer great value and can be less than complementary about the merits of diversifying for the sake of diversification.

The portfolio diversification marketing mantra can be most dangerous for people who find themselves with a large lump sum to invest. They might get lucky and invest the lump sum when the majority of the segments of the diversified portfolio are great value but equally they might get the short straw and invest just before a crash in a major portion of the portfolio, which is particularly relevant to the international equity market that generally makes up the largest share of diversified portfolios.

We are not actively in the investment advice business and do not claim to know all the answers but hopefully this Raving will help stop some people from being drawn blindly into the potential trap of diversifying for the sake of diversification. In the context of house price prospects, an area we do specialise in giving advice to a range of firms and some individual investors via our **Housing Prospect** reports, we both assess whether housing is good value and have a method of assessing the near-term outlook for house prices. In my view the best active investors have both a framework for assessing value and a basis for deciding whether it is a good time to invest. And if an investor doesn't have these in his/her toolkit then maybe he/she should go down the route of diversifying for the sake of diversification albeit hopefully with a bit more insight after reading this Raving.



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What sort of diversified portfolio is relevant to long-term investors/savers?

The Strategic Asset Allocation adopted by the NZ Super Fund is a useful benchmark to look at in assessing what a diversified portfolio should look like for an investor with a long-term investment horizon. The target is 40.5% in global equities (mainly large cap global companies), 20% in private markets (a mix of private equity, infrastructure, other private markets and timber), 17% in fixed interest, 10% in property, 7.5% in NZ equities and 5% in commodities. (Source: <http://www.nzsuperfund.co.nz/index.asp?pageID=2145831975>). Aside from the occasional hiccup, like when the global equity market takes a caning, the NZ Super Fund seems to have performed well with an 11.49% pa average rate of return since inception in September 2003. (Source: <http://www.nzsuperfund.co.nz/>).

Why diversify?

“A simple example of diversification is this one. On a particular island the entire economy consists of two companies: one that sells umbrellas and another that sells sunscreen. If a portfolio is completely invested in the company that sells umbrellas, it will have strong performance during the rainy season, but poor performance when the weather is sunny. The reverse occurs if the portfolio is only invested in the sunscreen company, the alternative investment: the portfolio will be high performance when the sun is out, but will tank when clouds roll in. To minimize the weather-dependent risk in the example portfolio, the investment should be split between the companies. With this diversified portfolio, returns are decent no matter the weather, rather than alternating between excellent and terrible.” This example is sourced from Wikipedia, the useful online encyclopaedia ([http://en.wikipedia.org/wiki/Diversification_\(finance\)](http://en.wikipedia.org/wiki/Diversification_(finance))).

My first response to this example is to suggest that prior to the rainy season on the island, when the share price of the umbrella company is hopefully low after experiencing dismal sales during the sunny season, investors should buy shares in the umbrella company. Equally, why not sell the umbrella company's shares at the end of winter and buy shares in the sunscreen company? Timing markets this way has shown to be problematic and in some investment circles has a bad name. This is partly because it is seldom as black and white as rainy season followed by sunny season, while even if it was there would still be a guessing game related to when the seasonal weather effect got built into the share prices of the umbrella and sunscreen companies. An investor who waited for the first drop of rain before buying shares in the umbrella company could pay peak price for the shares if fleet-of-foot investors anticipated the onset of the rainy season and bid the share price to dizzy heights well before the first rainfall. So while timing financial markets is one of my favourite games it is certainly not for everyone.

Portfolio diversification can help stop poorly-informed and/or overly-confident investors from losing their shirts on the latest investment craze. We just have to look at the significant number of investors who have been burnt badly by putting large lumps of their investment money in the Auckland apartment market, topped up with a generous dose of debt, to be reminded of the value of a diversified portfolio of investments in reducing the risk of losing everything. For example, “The first of the Auckland apartments owned by investors in troubled Blue Chip has hit the market, causing misery for its owners. They lost \$192,000 when their 40sq m unit in Tetra House on Wakefield St went under the hammer after fierce bidding. They will pay a further \$15,000 for auctioning and marketing, recording a total net loss of \$207,000 on an investment meant to help them save for retirement.” (Source: NZ Herald, 6 March 2008)

If you are saving regularly and have a long-term investment horizon then the sort of diversified portfolio that the NZ Super Fund operates makes sense in part because it enables access to some investments the average person couldn't get their hands on easily. Another positive for people building up their long-term retirement savings using a diversified portfolio of the sort run by fund managers is that it puts the focus on saving regularly, while the money gets put aside at least somewhat out of reach/temptation.

Because I control my own investments and am somewhat of a lazy investor it means that at times I have lumps of money sitting in the bank or in interest bearing facilities waiting for a great investment to crop up. But great investments don't crop up every day so patience is a key ingredient to DIY investment success, as well as doing quality homework before parting with hard earned money. I have the discipline required not to treat myself using money earmarked for long-term savings too often, but my suspicion is that many people do not have the self-control to gradually build up nest eggs under their own management without regularly dipping in for a treat. So for this group there is merit in regularly saving with fund managers who manage diversified portfolios even if the after-fees returns are not earth shattering. If only I had the same self control when it came to treats like dark chocolate my cholesterol count would look as healthy as my bank account, although the more cholesterol I eat the less I need to worry about saving for retirement.

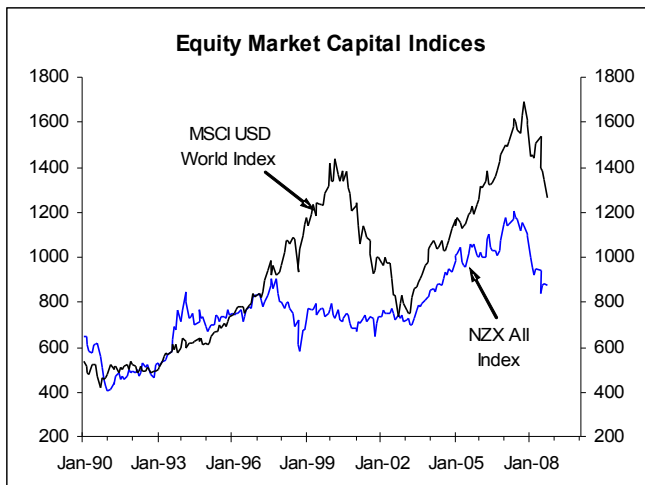
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The portfolio diversification marketing machine

There is a sea of academic studies showing that few investors can beat the markets, meaning that for most investors portfolio diversification is as good as it gets. It is certainly better than getting burnt in the latest investment craze. And on the foundation of the academic studies has grown a marketing machine, personified by the financial planning industry but going well beyond this, which generally uses portfolio diversification as something of a mantra in marketing investment services and products to investors.

This is not to say there is anything sinister going on, but portfolio diversification is a gift from heaven for anyone marketing investment services and products who couldn't tell a quality investment if they trip over one. The following two examples of people who got drawn into the web of portfolio diversification and spat out much worse for wear give insight into when diversifying for the sake of diversification can be a bear trap for unwary investors. Problems can particularly arise when someone has a large lump sum to invest, like after receiving an inheritance or after selling a business or property.



The first example relates to a nice lady who inherited a sizeable lump sum of money and was happy to have it sitting safely in the bank earning interest. The money was vested in a family trust and one of the trustees, an accountant, persuaded her that the prudent thing to do was to invest the money with a fund manager because that way it would be in a diversified portfolio that was safe and provided the potential for higher returns. The lady succumbed to what in most circumstances would be sound advice, but the money was put in a portfolio that had a high weighting in the international equity market just in time for it to fall around 40% over 2001 and 2002.

The black line in the chart shows the tumble in the world equity market over this period based on the MSCI World Equity Index. The international equity portfolio the lady was put in had a significant weighting to the NASDAQ Index that tumbled much more than the world market, so when I came across her she had seen around 30% of her inheritance disappear in a short period of time. Of course if she stuck in there eventually it would have come right, but you can bet that no one warned her that her "safe" diversified portfolio could turn so nasty that she was regularly losing sleep over it.

The second example was also associated with the demise of the world equity market over 2001 and 2002. In this case the investor in question had earned a large lump of money selling the rights to a new invention to a US company. He confessed to having no knowledge about investing so he consulted people he thought were the experts and was soon fitted with a diversified portfolio of investments much like our unlucky lady. At the time of meeting him he had suffered the same fate (i.e. around 30% of his lump sum had gone down the gurgler with the collapse in the world equity market). He was remarkable calm about it, probably because he was mainly occupied with finding the next winning invention, but he was more than a little disappointed that the people who so convincingly sold him the merits of a diversified portfolio didn't warn him how painful such things could get before the long-term Navarra came over the horizon.

Recent market events means there will be more unlucky investors who got fitted into diversified portfolios just in time for the proverbial to hit the fan. If an investor was unlucky enough to put 40.5% of his/her money in the world equity market in October 2007 and 7.5% in the NZ equity market, he/she would have lost around 25% of the capital value in the world equity market and around 23% of the capital value in the NZ equity market as at 12 September 2008 based on the performance of the MSCI World Equity Index and the NZX All Index (see the chart).

A properly constructed diversified portfolio should mean it is unlikely that major losses will be made in all segments of the portfolio at the same time. For example, the benchmark US 10-year bond yield rallied from 4.7% in October 2007 to 3.4% currently, which means the fixed interest segment of a diversified portfolio should have delivered significant capital gains. But as the examples above show, a diversified portfolio is



not a panacea for all investors in all circumstances, especially when lump sums of money need investing. But in recent times there have been some worse abuses of portfolio diversification.

The golf course is a useful place to understand the joys and woes of everyday New Zealanders. The recent experience of a number of the retired people who make up the backbone of many golf clubs around the country with the finance company debacle is another example of the marketing-focused disciples of portfolio diversification hanging clients out to dry. It has horrified me to hear how many retired golfers were advised to invest a sizeable portion of their nest egg in a diversified portfolio of fringe or semi-fringe finance companies. And this was supposed to be the safe part of their portfolio from which they gained regular income and had virtually no chance of making capital losses.

It is normal for retired people or people with low risk tolerance to have a much larger share of their portfolio invested in fixed interest securities than the benchmark used by the NZ Super Fund (see page 2), including some in the likes of finance company debentures to achieve a higher yield. But I believe the fact that retired people were advised by some investment advisors to have significant portions of their money invested in the likes of Bridgecorp, Western Bay Finance and National Finance is a prime example of the mantra of portfolio diversification being abused. Diversification is no help if it is used without consideration of the underlying value or risks involved in the specific investments in the portfolio.

Another problem that can occur at times with portfolio diversification is a tendency for asset allocations to drift in response to market performance. For example, if the world equity market has a fantastic run over a number of years, like between 1993 and 2000, it becomes a growing share of the diversified portfolio unless fund managers/investors actively remove money from the world equity market segment of the portfolio and invest it in other segments. Certainly many fund managers and some investors will have done this, but from my observations it is not uncommon for asset allocations to be allowed to drift in favour of a strongly performing segment of the portfolio so that when it does eventually tumble the portfolio is over exposed to it. Equally, if a segment of the portfolio performs poorly over a protracted period it is not unusual for it to be allowed to shrink as a percentage of the portfolio. Consequently, diversified portfolios often end up most exposed to markets, like the global equity market, when they peak and least exposed to them when they are at trough levels, which runs counter to a value-focused approach to investment.

The missing ingredient in the portfolio diversification mantra

So what is the alternative to blind faith in portfolio diversification? In the perfect world it would be a dose of good old fashioned values of the sort used by the long-standing successful investors like Warren Buffet (http://en.wikipedia.org/wiki/Warren_Buffett) and Peter Lynch (http://en.wikipedia.org/wiki/Peter_Lynch). The idea of handing money over to someone so they can spread it around a wide range of markets without consideration of whether those markets offered good, bad or indifferent value is an anathema to the likes of Buffett and Lynch. To the best investors in the world the pursuit of value and in particular screamingly cheap value is the objective.

Few people have the ability to assess when the world equity market or any other market is screamingly over-priced or great value, so there is no easy solution for investors who suddenly find themselves with a large lump sum to invest. They could approach a range of investment advisors and ask them whether any of the markets currently offer particularly good value (e.g. international equities, local equities or fixed interest securities). But my assessment is that few investment advisors have a sound basis for making such recommendations, while based on the creed of diversification many will probably respond by telling you that trying to time markets is a bad idea and that you should just hand over your money and let them invest it in a diversified portfolio. The mantra of diversification has become so powerful you risk being considered a weirdo if you worry too much about whether your money is being invested in things that are genuinely good value or extremely over-priced.

One possible solution is to drip-feed your lump sum of money into managed funds over a significant period of time on the basis that it reduces the risk you could be investing when a sizeable portion of the portfolio could be expensive. While if you were particularly worried about preserving the real value of the lump sum you could put it all into a diversified portfolio of NZ bank deposits or similarly safe fixed interest investments with low risk of default and live with the prospect of returns that will generally be only mildly positive on an after-tax, after inflation basis, but which let you sleep soundly.

My own inclination would be to store the lump sum windfall in low risk interest bearing deposits/investments and wait for the proverbial to hit the fan in the markets I was most interested in, as it has recently in both



the global and local equity markets, and is in the process of happening in the housing market, then look to invest in them. But even then you can't be sure you are buying close to the cyclical low in the markets but I'd be more confident investing in the NZ and international equity markets now than I was a year ago when various shadows were just starting to be cast over them. The best value in equities markets is generally when a recession is taking firm grip of the economy and share prices have tumbled but the central bank is starting to cut interest rates to underwrite a recovery.

The exchange rate would also have to be taken into account when considering investing part of the lump sum in overseas markets (e.g. investing in international equities after they have taken a hit may not be such a good idea for a NZ based investor if the NZ dollar was extremely low at the time). A way of taking into account the exchange rate would be to invest a portion of the lump sum in low risk, short-term international fixed interest funds when the NZ dollar was extremely high, as it was recently, so you get the advantage of great value from the exchange rate, and then transfer the money in to an international equity fund after the international equity market spat the dummy or in to an international bond fund after yields had blown out in the international bond market (assuming the cost of transferring from one fund to another wasn't prohibitive).

Our approach to analyzing the housing market is, I believe, a good basis for thinking about investing in any market for active investors (i.e. those wanting to make informed decisions rather than either get caught up in the madness of the crowd or captured by the mantra of diversifying for the sake of diversification without regard for value). We assess both the value of the housing market (i.e. is it a good, bad or indifferent time to invest) and near-term prospects for the market (e.g. what are house prices going to do in the year ahead). In my view the best active investors have both a framework for assessing value and a basis for deciding whether it is a good, bad or indifferent time to invest.

In early 2007, for example, the valuation indicators we use already said the NZ housing market represented extreme poor long-term value for investors. If we focused only on value we would have advised clients to exit the market to avoid making large losses. But based on our analysis of near-term prospects we picked that the national median house price would increase 7% or so during 2007 - the outcome was a 7.2% increase based on the average of the REINZ and QV house price data - so we were not ringing the warning or exit bell early last year. However, by February this year we were predicting that the national median house price would fall during 2008 so we started to ring the warning bell. In our **March Housing Prospects** report we warned that the national median house price could fall 7-10% this year, which looks to be roughly on the mark still, while we also warned that this would be only stage one of the fall in real house prices, with much more downside risk ahead.

I believe that when armed with a quality framework for assessing both the value of a market and the near-term prospects for the market, like the framework we have for assessing the NZ housing market, it is possible to make good decisions about when to enter and exit the market in pursuit of higher returns than can be offered by a diversified portfolio. But if you have the urge to be an active investor I encourage you to make sure you have a sound basis for assessing value, and asking a mate or someone with a rudimentary understanding of how financial markets work, which includes many of the people marketing financial services and products, does not represent a sound basis for assessing value. Just as asking many real estate agents about whether housing currently represents good value as an investment can be a bad idea. And you need a reliable means of assessing when good or bad value is likely to come home to roost, although the likes of Warren Buffett focus most on assessing value and don't believe it is as easy to assess when a great value investment will bring home the bacon. Otherwise you are at risk of being whiplashed by the markets in ways that could make diversifying for the sake of diversification a virtue.