Spreading Your Risk – May 27, 2021

Portfolio diversification will help protect your investments and increase returns on these investments.

Portfolio diversification is the spreading of risk by investing in several asset categories (equity, bonds, cash, real estate or precious metals) or several industries or several different markets. How does diversification help reduce your investment risk?

How Diversification Reduces Risk

Let us suppose that your portfolio consists of one stock. What is your risk? There is the broad risk that comes from the general economy, such as the business cycle, interest rates, the inflation rate and exchange rates. Then there are the specific risks which come from the company's financial position, internal policies, marketing efforts, etc. These latter risks are specific to that company and not to other companies in the economy. By adding another company with a different business, you reduce your portfolio risk as long as the firm-specific influences on the two stocks differ.

Now assume that your portfolio consists of an airline company and a computer company as an example. When oil prices rise, airplane fuel price increase, which in turn lowers the airline's profit margins. At the same time, computer chip prices may be declining, improving the margins of computer manufactures. The two effects offset one another, stabilizing the portfolio's returns.

A client's equity position can be spread over many sectors of the economy including industrials (chemicals and auto manufacturers), financials (banks and insurance companies), energy (oil and natural gas producers), forest products (newsprint and market pulp), transportation (airlines), retailing, health-care, and communications.

By adding more stocks with different characteristics, one can lower the risk by spreading it over many equity positions. However, you cannot eliminate risk. No amount of diversification can reduce an investor's risk to zero. When all risk is related to a specific company, the diversification can reduce risk to very low levels. The remaining risk is market risk which is non-diversifiable. Any claims of a 'riskless' investment should be treated as dubious. Although there exist complex quantitative techniques that are designed to hedge against risk, they can never eliminate it.

As a Hong Kong-based investor, you should consider diversifying internationally since both the stock market and the local economy are heavily geared to real estate. It is impossible to diversify into a broad range of industries so one should look abroad. International diversifications can improve portfolio performance.

The value of the whole Hong Kong Stock Exchange is approximately US$6 trillion of which only half is open to investors. An adjustment must be made for corporate cross-holding, legally restricted shares, large private holdings, etc. Although this may appear a large sum, it is small when compared to the world's major equity markets. The US and Chinese markets have a combined value of approximately US$60 trillion, Hong Kong represents only 10 per cent of these two markets. The other Asian equity markets, other than Japan, are even smaller, in comparison.

Diversifying Internationally

There are many possible approaches and many different views on how to diversify internationally. Some of the steps you should consider are the selection of currencies, industries, companies, countries and securities.

You could choose a mutual fund which covers the countries and currencies you wish and the fund will select a diverse portfolio of securities for you. A private banker or broker with an international firm can provide you with research materials to back up any suggestions that they may have. Some discretionary fund managers specialize in providing international diversification in equities and fixed income.

Conclusion

Diversification helps to reduce investment risk and to increase returns for your investments. Just remember that you have to keep your initial investment objectives in mind when choosing a method that works best for you.

Contact Us:

ChapmanCraig Limited
2507 Tower Two, Lippo Center, 89 Queensway Road, Hong Kong
www.ChapmanCraig.com T: 852 2521 7218 E: Info@ChapmanCraig.com