

# Portfolio diversification research paper

[Business](#), [Marketing](#)



## **Abstract**

The modern mantra of corporate risk management is fast becoming “ A risk is risk is a risk.” Large, multinational companies are no longer prepared to approach risk management on a single risk-by-risk basis. It makes no sense for a manager to accept a potential \$30m loss in the organization’s currency-trading activities and simultaneously hedge against a \$10m loss on a suburban office property. Risk managers now realize that any particular risk can have consequences for many seemingly unconnected parts of the business-losses in one part of the business might be offset by gains elsewhere in the organization that result from that loss event. Just as financial investors can lower the risk in their investment portfolio by sensible diversification, so managers can benefit from continual review of their entire corporate project portfolio.

## **Introduction**

Susan Payton in her article ‘ The Importance of Portfolio Diversification’ says “ The best strategy for long-term investment growth is to have a diverse portfolio of financial instruments. Spread your risk across many investments to be financially savvy.”

A portfolio is a set of securities and assets held by institutional or individual investors and diversification is investing these assets and securities in to a variety of instruments in order to reduce risk with affecting the returns.

## **According to NASDAQ, portfolio diversification is**

“ Investing in different asset classes and in securities of many issuers in an attempt to reduce overall investment risk and to avoid damaging a

portfolio's performance by the poor performance of a single security, industry, (or country).”

The assets are diversified in order to mitigate the associated risks in a portfolio. Diversification does not necessarily guarantee against loss or does not ensure a profit rather the main purpose of diversification is to reduce the volatility in a portfolio to minimum. Apparently it is a straight forward strategy but it brings along quite complex iterations. Yet at the root, diversification is simply spreading the portfolio across asset sectors and classes that may include foreign stocks, short term investments and bonds. A well diversified portfolio has generally divided its investments over 4 asset classes; stocks, bonds, short term investments and international stocks and bonds.

When an organization operates in a number of businesses, the declines in one can be compensated by the uplifts of the other. The portfolio theory suggests that an unsystematic risk; that is the risk associated to a firm or an industry can be diminished rather eliminated by forming a diversified basket of stocks and securities. Ideally this strategy minimizes the inherent risk in any one investment and subsequently increases the probability of earning higher profits or at least avoiding any substantial losses. A shortcoming of this is that it may reduce the expected returns but it all depends upon the type and level of diversification. Majorly there are two types of diversification; Horizontal diversification and vertical diversification.

Horizontal diversification involves investments made in similar type of business or securities etc, for example investing only in bonds or in several manufacturing companies. Whereas in vertical diversification investments

are made in different securities; for example investing in securities at global level. Both the types may be as narrow or broad as the investor opts.

Generally broader diversification will result in fewer returns and less risk.

Few other analysts categorize diversification as related and unrelated diversification. Related diversification involves investment of the company beyond the current product and market, yet remaining in the same industry using the present strengths and expertise. This form of portfolio diversification can be further divided as;

- Backward diversification; that is input activities in the business are enhanced and developed.
- Forward diversification; developing the output related activities of the business.
- Horizontal diversification.

### **Unrelated diversification however refers to moving present interests into unrelated products or markets.**

In order to attain best possible returns over time, investors should work out an ideal asset allocation plan that fits their risk reservations and adhere to it.

In the past the investors who have tried to switch strategies at the time of economic downturn in 2008, probably regret their decisions today.

Shefali Anand in an article ' Learning from History; The randomness of the past leads Nelson Lam to spread clients' money widely' reports Mr. Lam's opinion on diversification;

" In times of high stress, it's best not to do anything, it could be very damaging to your overall financial well-being."

## **Need and Importance of Diversification**

It is a common saying “ Don’t put all your eggs in one basket.” The statement best sets on the money market or financial investing.

A well diversified portfolio comprising of different types of securities can minimize the risk associated to the investment when a single stock or security’s value drops. If a business has all its assets invested in one security and that security’s value drops by 50%, the business would lose half of its wealth in terms of asset value. However if the business owned 50 securities and the value of any one of those drops, the business will lose only 1% of its asset value. This is what diversification all about. Nevertheless it should be kept in mind that this strategy does not ensures profits neither it guarantees protection against loses. The purpose to diversify is to aid in reduction of the risk to the lowest possible level.

## **Jason Zweig in his famous article on wall street journal ‘ A ‘Bucket List’ for Better Diversification’ says**

“ If you care about risk, not just return, you could be forgiven for just wanting to bury your money in your backyard.”

He further relates the need of diversification with the rise and fall of prices with the growth of economy and subsequently a shrinking economy may suffer from either extremely low or high inflation, and this is the precise reason for the businesses to have investments in different buckets. Jason is of the view that the business shall manage such a diverse portfolio which is consistent, he does not recommend sloshing the money around. Rather small investments shall be made and maintained as lifelong insurance against other’s ignorance to the future. Meanwhile it should once in while ‘

play around the edges' yet adhering to basic and simple diversification will keep the business in a better situation in the long run.

Risk is considered as the unpredictability of the future value of the investment in the world of investing. Where as return is a decrease or increase in the investment value. Studies have shown that there exists a tradeoff between the risk and return, investors taking higher risks will expect higher potential returns as a compensation for the risk taken. Markets as well tend to the price investments in order to translate the expected returns and perceived risks. Diversification is the phenomenon that balances the risk and return. The values of bonds and stock often have an inverse relationship. Large cap stocks and small cap stocks also behave differently. Also the stocks chosen considering a value approach perform differently from the growth stocks. A combination of large, midsize and small company stocks, foreign stocks and incorporation of value and growth styles of investing makes a diverse portfolio carrying different risks for different level of expected returns.

Diversification is also important due to the highly volatile and unpredictable market trends. Another reason that adds to the importance of diversification is the efficiency gains; when a business has underutilized competences and resources that the business is unable to sell or close, the business shall than use the competences and resources in diversification into other activities. In order to increase market power, the organizations cross subsidize a business by the gains from the other investments in a manner that its competitors are unable to do, and diversification is the best tool for that.

In order to stretch corporate parenting capabilities in to products and

markets as well to respond to the market declines and to spread the risk, diversification is a highly efficient and effective tool being successfully exercised worldwide for many decades.

## **How to diversify**

M. O’Keeffe, (chief investment officer for Merrill Lynch Wealth Management), says in an article;

“ A typical investor today, should start with a globally diversified portfolio of stocks and bonds plus a modest allocation to cash, and then consider adding real assets such as real estate, commodities, and Treasury Inflation-Protected Securities”.

He further suggests “ Overall, an investor should keep his or her risk appetite in mind, he says, and be globally minded across multiple asset classes.”

## **Few other ways of constructing and maintain a diversified portfolio are;**

- Spread the wealth; investments shall be made in a number of stocks and in different stocks.
- Consider index or bond funds; consider investing in fixed income funds or index funds, such securities prove to be a healthy long term investment for a diversified portfolio. Adding the fixed income funds, the portfolio is further hedged against market uncertainty and volatility.
- Continue building; the business shall keep on adding investments regularly because in today’s economic scenario lump-sum investment does not work any more.

Know when to retract; business managers shall always keep an eye on the market situation and the fluctuations related to their investments. They shall

have a sound insight and know how of when to retract their investment in order to avoid any substantial loses. As discussed earlier a well diversified portfolio has generally divided its investments over 4 asset classes; stocks, bonds, short term investments and international stocks and bonds. A smart and strategic mix of these asset classes can structure a portfolio with lesser extreme fluctuations than the undiversified ones. In the following discussion a pie chart is presented as an example to demonstrate the formation of a well diversified portfolio with investors with different approaches

Data Source: Ibbotson Associates, 2010 (1926–2010). Past performance is no guarantee of future results. Stocks are represented by the Standard & Poor's 500® Index (S&P 500®)

[www.fidelity.com](http://www.fidelity.com).

The pie charts above show portfolios with different allocations made for different risk profiles. The most aggressive portfolio comprises of 70 percent U. S. stocks and remaining 30 percent are the international stocks; this portfolio had an average annual return of 10 percent. The portfolio touched the highest one year return on 163 percent to a loss of approximately 68 percent, which is extremely volatile behavior of the portfolio. Adding a small amount of fixed income can however reduce the range of this volatility without giving up much. An addition of 25 percent to the bonds and allocating 5 percent to the short-term investments, plus reducing the stock allocation to 49 percent and international to 21 percent, the portfolio returns would have been approximately 9 percent over the same period but with minimized extremes on the low and high end.



## **Disadvantages of Portfolio Diversification**

Along with so many benefits of portfolio diversification, there are a few disadvantages as well, for instance as discussed earlier being risk averse reduces the expected returns which ultimately may result in slower growth of the business. The process of diversification also, in addition to the direct financial costs, increases the management cost and adds to the bureaucratic complexities being necessitated by control and coordinate requirements for the basic activities along with additional activities. Firms may also incur loss during the process of market consolidation that may result in subsidized business units. In addition to this, negative synergy is also a possible outcome of portfolio diversification. Diversification being done via domestic or global acquisitions may have certain legal and political intricacies and the company might encounter interest controlling issues. Also experience and competences of the acquired and acquirer shall be on the same wavelength, if not diversification would be a failure.

## **Conclusion**

Portfolio diversification is basically spreading the funds of a business in many assets so as to minimize risk. Organizations have adopted certain techniques for diversification. Those who focus on exploiting the core resources and integrating new and old businesses generally outperform the organizations that concentrate on existing resources and do not encourage interrelationship between different units. A well diversified portfolio comprises of number of strategies mixed and balanced well in order to achieve maximum benefits.

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