EFFICIENT GROUP

ECONOMIC COMMENTARY

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YOUR WEEKLY ECONOMIC UPDATE

8 November 2023

WHY DIVERSIFICATION MATTERS

Nobel Prize winner Harry Markowitz famously said that diversification is the only free lunch in investing. In simple terms, this means that you can quite easily keep your expected level of return constant, or even increase your expected return, without taking on additional risk. Diversification is one of the most important principles in investing: It involves spreading your money across a variety of assets or even across asset classes.

Diversifying your investment portfolio holds many benefits but perhaps the most prominent one is reducing overall portfolio risk. No single investment is risk-free, and even the most stable investments can experience losses from time to time. It is, therefore, sensible to include various assets that are uncorrelated, which, in essence, means that the prices of the assets move independently over time. If one investment loses money, the other investments may achieve gains, offsetting some of the losses and thereby lowering the overall portfolio risk. Over time, all of the portfolio investments are expected to achieve an acceptable level of return but the uncorrelated nature of the individual assets helps to reduce the short-term volatility of the portfolio and, therefore, lowers the total portfolio risk.

A practical example of differentiating between assets within a specific asset class is to combine a healthcare stock and a mining stock in a portfolio. As the economic cycle evolves, the mining stock may experience impressive returns as the prices of resources tend to increase when an economy expands, while the healthcare stock may experience relatively muted gains. But, as we reach the end of the economic cycle, resource prices may start to decline, which is generally bad news for mining stocks, while the healthcare stock becomes more attractive as spending on healthcare tends to be unaffected by the economic cycle. Another alternative is to diversify a portfolio by investing in various asset classes. Asset classes are broad categories of investments, such as stocks, bonds, real estate and cash, or alternatives such as hedge funds and private equity, among others. Each asset class has its own unique risk and return characteristics, and are generally uncorrelated with one another. By investing in different asset classes, an investor can reduce their overall portfolio risk.

Taking it a step further, investors can also diversify their exposure across various investment managers. Active investment managers tend to follow distinct strategies, constructing portfolios based on individual asset valuations, expected earnings growth, secular themes, or macro-economic expectations. As can be expected, and already confirmed by many studies, these different investment strategies generate returns that are, on average, uncorrelated with one another. This creates an opportunity for investors to diversify some portfolio risk without necessarily lowering their return expectations. Fortunately for investors, investment experts at Efficient can assist investors who do not feel comfortable constructing their own investment portfolios. A financial advisor can help you to assess your risk tolerance, develop an investment plan, and choose appropriate diversified investments for your portfolio so that you can achieve your long-term financial goals.

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