

The Importance Of Portfolio Diversification

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Portfolio diversification is distributing one's wealth into different asset classes like cash, debt, equity, property, gold, art and so on. These asset classes have a certain return expectation and risk attached to it.

Risk: Risk is defined as the uncertainty or variation in the return expected from an asset class. This risk could be measured in terms of standard deviation of an asset class. Risk can be categorised as below:

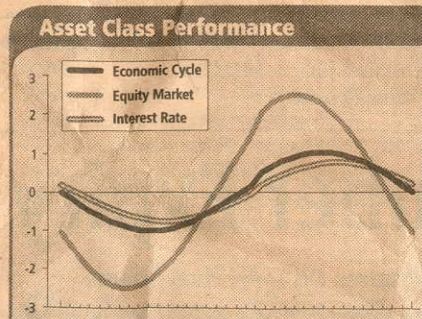
Systematic Risk: Systematic risk is defined as a risk which arises in all the risky assets because of macro-economic factors like earthquake, floods, war, etc. It cannot be eliminated through diversification.

Unsystematic Risk: Unsystematic risk is defined as a risk which is unique to a particular asset class and could be eliminated or reduced by diversifying a portfolio.

How Diversification Helps Eliminate The Unsystematic Risk?

One must take into consideration the correlation between various asset classes while diversifying the portfolio.

Correlation is the measure of the degree to which two asset classes move together in a given atmosphere. If they move in the same direction it is positive correlation and vice-versa.



Adding negative correlated or non correlated products in the portfolio helps in reducing the unsystematic risk. It is based on the fact that various asset classes behave differently as maturity & volatility of these assets differ and there is a time lag between asset class performance and economic cycle performance.

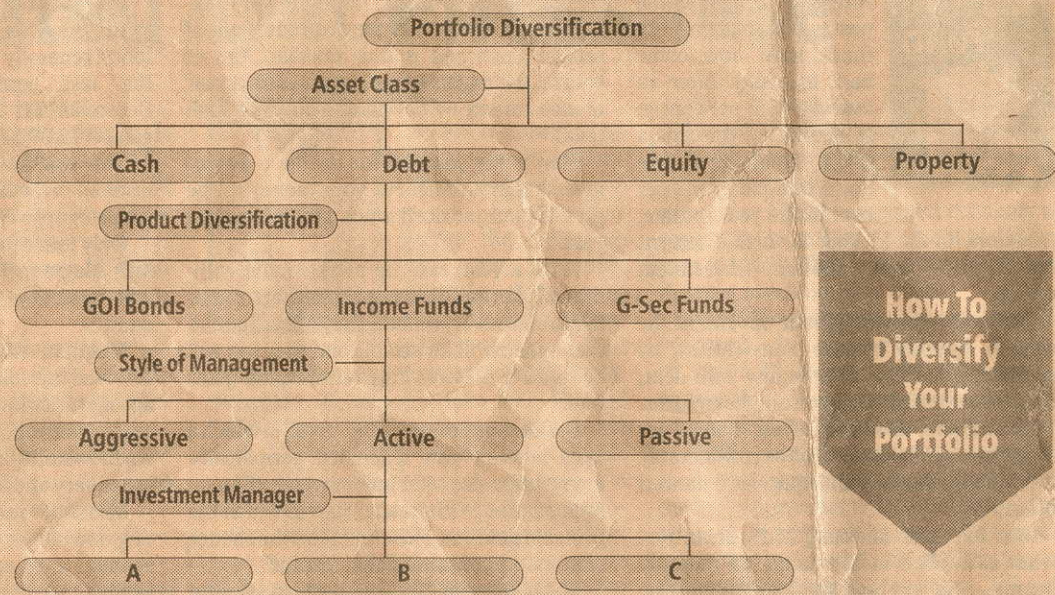
Model Portfolios

Portfolio diversification could be achieved by designing model portfolios with the objective of diversifying the client portfolios across:

Portfolio Styles: The composition of various equity portfolios may differ across the category of stocks. For example, for some portfolios the investment universe may be restricted / focused on large-cap, mid-cap, small-cap or speciality stocks.

Investment Management Style: The style of management may be growth investing, value investing, tactical investing across sectors in vogue, etc.

Investment Managers: These are the various asset management companies whose



fund managers have a direct impact on the performance of the portfolios being managed by them.

Due to a variety of reasons no single attribute mentioned above would always remain the topmost performer consistently. However, if one remains invested across an optimal allocation towards each of these attributes, one could benefit from the out-performance of any one or could get shielded from the under-performance of any of the components.

What Is Essential For Model Portfolios To Work?

The single most factor that is important for the model portfolios to work is the consistency in the investment management & portfolio positioning policies by the investment managers. This virtue is called "True to Label" and is constantly scanned by Client

Associates because any deviation from the declared policy would lead to unexpected portfolio performance for the simple reason that the attributes itself would have got altered.

For example, if an investment manager changes his investment management style from value investing to growth investing, the inherent allocations of the model portfolio towards these attributes would get altered leading to unexpected performance.

Factors To Be Taken Into Account While Diversifying The Portfolio

Personal financial plan, investment horizon, return expectation & risk profile of an investor should be taken into consideration while selecting the asset classes and diversifying the portfolio. ♦

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