

Title: The Death of Portfolio Diversification

Country: INDIA Date: 04th December 2009 No of Pages: 5

The most frequent of advices in managing your investments that many of us might have received is “Don’t put all your eggs in one basket”. That’s nothing but “Portfolio Diversification”. In other words, put your money in different asset classes such as stocks, bonds, commodities, real estate, currency etc, so that the overall portfolio risk is lower and is not concentrated in only some of the asset classes. The proportion of allocation to different asset classes is a function of balance working years, risk appetite, liquidity requirements, tax constraints etc of the investor, which is not the focus of this note.

Portfolio diversification is investing your portfolio into a basket of different assets, the returns of which are negatively co related viz the returns of which are completely independent of each other or move in opposite direction. So that negative returns from one is

compensated by positive (or less negative) from other and vice versa. Historically, if an asset A is expected to return -8%, Asset B is expected to say +10% or so. In simpler words one particular risk for an asset class, may be a positive for another. It’s important to understand that relationship of returns (positive or negative) within different asset classes in a portfolio drives the overall portfolio risks.

For instance in global context US Dollar and Gold typically enjoy a negative co relation. Gold does well when US Dollar is weaker. From an Indian perspective Stocks and Bonds, are traditionally negatively co related. Gold and Indian stock markets (for instance in 2008) to a certain extent fall in the same category. It’s very difficult to find a pair of asset classes which are perfectly negatively co related viz (Asset A 10% and Asset B -10%).

Table I : The Benefits of Diversification : An Illustration

Diversified Portfolio	Proportion	Returns	Concentrated Portfolio	Proportion	Returns
Asset Class A	25%	10%	Asset Class A	5%	10%
Asset Class B	25%	-15%	Asset Class B	50%	-15%
Asset Class C	30%	-25%	Asset Class C	40%	-25%
Cash or Risk Free Assets	20%	5%	Cash or Risk Free Assets	5%	5%
Portfolio Returns	-7.75%		Portfolio Returns	-16.75%	

Source : Delta Global Partners Research

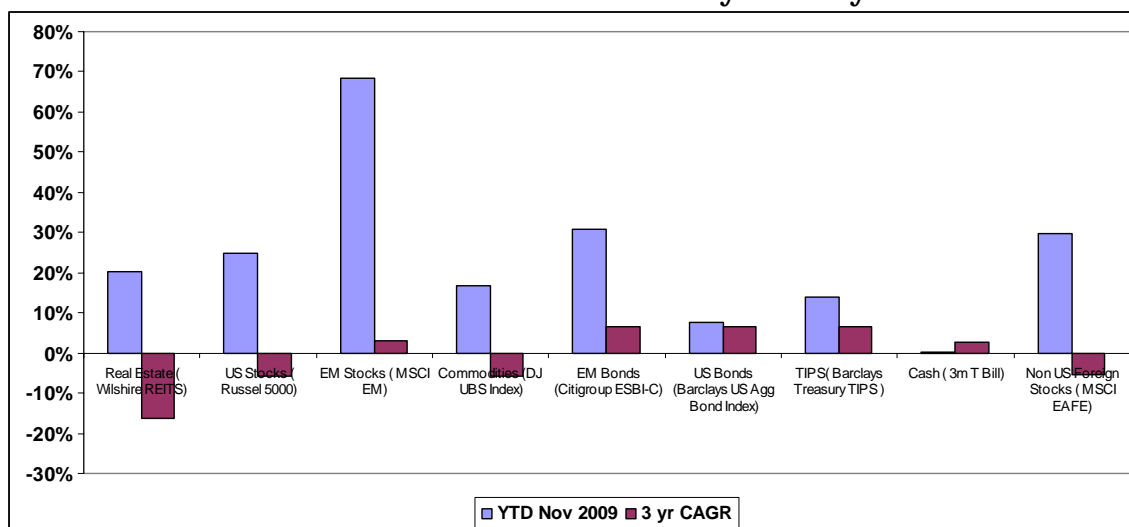
But does Portfolio diversification works to reduce portfolio risk in practice? Well it’s not a cake walk. The traditional diversification strategies across asset classes in India generally have been:

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1. Stocks and Interest Rates (GOI Bonds): When interest rates tend to rise (falling bond prices), generally stocks are expected to fall and vice versa.
2. Indian Rupee (INR) & Gold: Everything else remaining the same, a weaker INR should add to the domestic gold prices and vice versa.
3. Real Estate and Interest Rates (GOI Bonds): Higher interest rates (falling bond prices) are not good for leveraged asset classes such as real estate and vice versa.
4. The Stock markets often influence the short term movements of INR due to the strong capital flows link. A weaker market exerts pressure on the INR as outflows are anticipated.
5. Commodities and Stocks: The commodity prices and stocks have a complex relationship. Higher commodity prices drive the commodity stocks up and vice versa. And higher commodity prices drive the stocks of such companies down where the commodities are raw materials. But from a risk perspective they go hand in hand.
6. INR and Interest rates: A weaker INR usually results in higher interest rates and thus lower bond prices.
7. Buoyant stock markets usually exert positive influence on Real Estate albeit with a lag through the wealth effects channel.
8. Commodities and Interest rates: Generally lower interest rates are positive for commodities.
9. Cash is a fabulous portfolio diversifier tool since the returns from it has no co relation to any of the other asset classes

Chart I: Global Asset Class Returns in 2009: An year of Synchronization



Source: malaysiafinance.blogspot.com. YTD 2009 returns are up to 30th November 2009

But there are many hurdles and issues in achieving optimal portfolio diversification. And investors should be aware of these issues when they construct their portfolios. On the paper the portfolio might be well diversified but factually the story might be a little different.

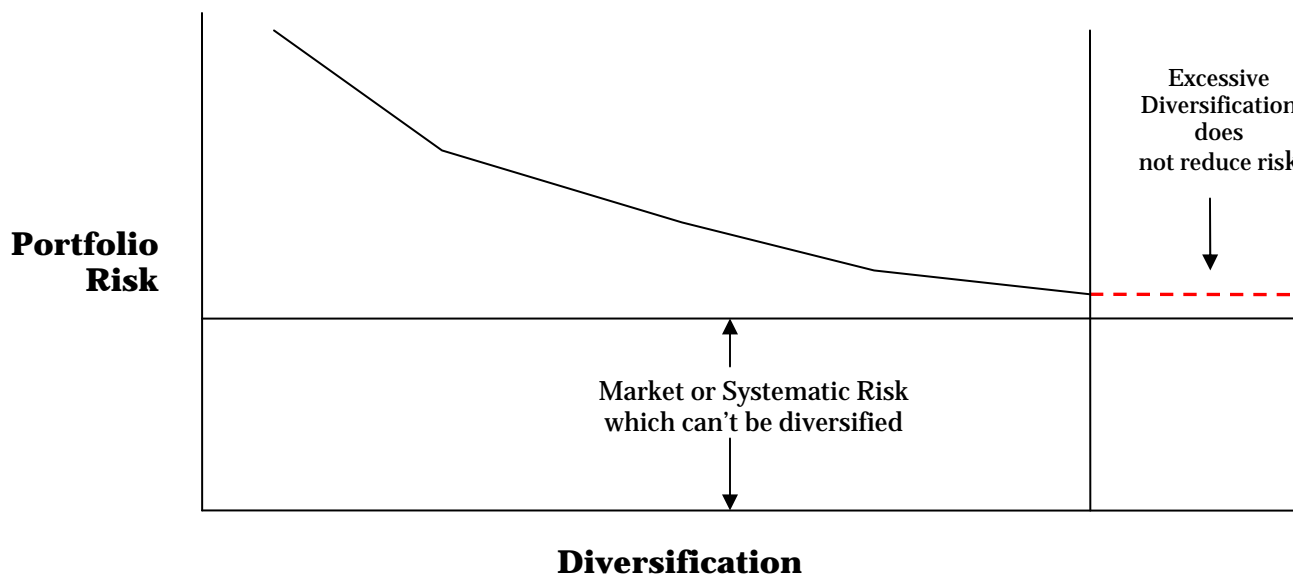
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Some of the issues that might come up as impediments in diversifying a portfolio are:

1. The portfolio can be diversified only to a certain (optimal) extent, beyond which one tends to get no benefits of diversifying more. On the contrary it increases the portfolio administration cost. Over diversification does not help in reducing the portfolio risk.
2. There are certain risks known as “Systematic or Market Risks” which cannot be reduced by diversification. For instance in stock markets, the general market risk cannot be diversified away. On a lighter note this risk is called as the “All fall down risk”, which cannot be escaped. One can't step into the swimming pool and not get wet too. This is the minimum risk one has to take on for being in the stock markets. Diversification cannot bring down the portfolio risk to zero.

Chart II : Portfolio Risk and Diversification



Source: Delta Global Partners Research

3. On the paper one may come up with a well diversified portfolio with appropriate allocation to different asset classes such as Stocks, Bonds etc. But in practice retail or smaller investors very often don't have access to many asset classes for regulatory or for other reasons. For instance in India the debt or the corporate bond market is a wholesale market and a small investor has hardly any access to it directly. Interest Rate futures have not taken off in volumes and provide exposure to only 10 years GOI Bond. Similarly for the real estate markets there is no vehicle for a retail

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- exposure. Mutual funds and portfolio schemes do remain a non customized option for some of such asset classes.
4. Illiquidity (low volumes) in some of the asset classes may distort the pricing of such asset classes thus rendering the pursuit of diversification an expensive option. For instance some of the debentures are listed on Indian stock markets but are very illiquid. Some of the Exchange Traded Funds are not very liquid too. The volumes on the commodity futures exchanges are not very exciting, apart from some top traded commodities. But as markets mature and develop, the potential for higher volumes has large upside
 5. In the time of a crisis, historical or traditional co relation between assets returns often tend to fall apart, rendering the diversification ineffective. In other words, during a crisis, many of the asset classes (especially the risky ones) often fall together and after the crisis is over, recover together too. This “Contagion Risk” can be hardly diversified except with may be cash. Such risks get amplified and transferred through the channels of confidence & financial flows to all the relevant asset classes. The 2008 Sub prime crisis is a classic example of the same. Globalization, financial integration and synchronized business cycles world over often dilute the objective of diversification.
 6. Excessive monetary liquidity (domestic or global) viz more and more money in circulation and lower interest rate often moves many of the asset prices higher in tandem, at least in the short run. This again leads to increasing the portfolio risk and the break down of the historical co relations of asset classes. “A rising tide lifts all the boats” and “Donkeys run along with Horses” leading to synchronized asset bubbles. Portfolio diversification hardly works in such scenario.
 7. Many a times a particular asset class your portfolio carries a specific or a new risk, which you need to now diversify viz buy an asset, the returns of which is negatively co related to it. Very often one may not find an asset in Indian markets with close negative co relation with existing asset. For instance your portfolio has fixed rate bond, to protect your return, you should buy a floating rate asset, which may or may not be available readily in the retail market. Or how will you diversify the impact of rising EMI's on your housing loan, as rates rise? Interest Rate swaps is a good option to cover that risk, but it continues to be a wholesale market.
 8. Taxation and other regulatory aspects can also be an impediment to optimum portfolio diversification.

In some of the above instances, it's important to look at your portfolio risk from a different perspective, a “Directional one”. It will be very useful to broadly categorize your portfolio assets into” Risky “and “Low Risk” buckets. There do exist very good chances that all the risky assets may move in same direction irrespective of the individual asset classes to which they belong to, especially during a liquidity driven rally or a financial crisis induced fall. And as discussed earlier increasing levels of low risk assets (such as cash) will prove very effective

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in reducing portfolio risk. Though rising inflation remains a risk to cash. But one can note here that Portfolio Diversification is not the only way to reduce portfolio risk.

Portfolio Diversification is indeed an important aspect of the risk control , but investors have to be aware of some of the scenarios when diversification is not effective and tailor there strategies accordingly, since historically asset allocation drive 90% of the returns.

To conclude, not putting all your egg in one basket is a good strategy, but what if the eggs in different baskets are from the same hen? All the eggs then are exposed to a common legacy risk. And one can't put the blame on the poultry owner, if all eggs are not of good quality.

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