FINANCIAL LITERACY FOR YOUTHS

Diversification

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Introduction

Is putting all eggs in one basket a right choice?

Source: http://www.altruisticleadership.com/2013/03/career-eggs/

There is an old saying: "Don't put all eggs in one basket". In terms of investments, if you were to concentrate and invest your money into a single area, you can lose everything if the outcome is not as expected. Diversification, a term that is widely discussed in online trading forums; the phrase that was printed in every single finance textbook available in the market, seeps in the mind of an investor as a necessity while managing a portfolio. It is essential to diversify your investments towards different types of financial assets to spread out the risk and prevent downfalls of the market from creating catastrophic losses to your capital. There are 2 types of risk that should be known while diversifying your portfolio.

Unsystematic risk

Unsystematic risk is generally uncertainties that originates from the internal activities of the company or due to policy changes that only affect a specific firm or industry. It is unlikely that these uncertainties are material enough to affect the market as a whole, hence it can be diversified away through diversifying investments within your portfolio. An example of unsystematic risk is the possibility of employees strike and mismanagement, leading to a slump in reputation, future profits of the company, and eventually the share price. For an investor who purchased shares from that company for investment, it is likely that the investor will suffer capital loss. A diversified portfolio attempts to prevent major losses of capital due to a single investment and hope that gains from other investments will be able to recoup any losses made.

Let’s have a real-life scenario to further illustrate this risk. Nearing the end of year 2013, your portfolio only consists of some property stocks (putting all eggs in 1 basket, facing high levels of unsystematic risk). However, Budget 2014 has doubled the RPGT (Real Property Gains Tax) for all holding durations of properties in an attempt to reduce speculation or “flipping” of property (the basket is shaking now). To react to this, investors are going to sell off their stocks in property companies as they forecast that these companies will generate lower profit due to lower demand of properties. This selling pressure increases the supply of the stocks in the market, and paired with lower demand for the stock, the stock price will drop. Thus, your portfolio will have a significant decline in value and have no other investments to cover the losses (the basket has now dropped to the ground, and all the eggs have cracked :( ).

However, if you have a diversified portfolio that holds shares in property stocks and a couple of stocks in plantation industry. Only part of your portfolio will experience the drop and it might be balanced by a rise in plantation share prices.

Systematic risk

Systematic risk is also known as market risk or undiversifiable risk. Unlike unsystematic risk that affects a specific industry, systematic risk is normally caused by macroeconomic factors such as inflation, recessions, wars etc that affects the economy as a whole. Regardless of how well diversified is your portfolio, it impacts your investments within your portfolio.

However, systematic risk affects different industry in different ways. The systematic risk in a portfolio can be identified by calculating its **beta**. Beta is a measure of the systematic risk or volatility of a portfolio or a security in comparison to the industry as a whole**.** A security with beta value of 1 will signify that the security is moving in line with the market prices. A beta value of greater than 1 means that the systematic risk is high, thus the price movements of the security is more volatile compared to the market, and vice versa.

Example, levered and unlevered beta values for Sunway Bhd (KLSE:5211)

Beta (Ref: KLSE)

	Levered beta	Unlevered beta
1-Year	0.44	0.33
2-Year	0.17	0.13
3-Year	0.35	0.26

*levered = company with equity and debt

*unlevered = company with pure equity

Since all the beta values are lower than 1, this means that the systematic risk is low and the stock prices will not be volatile, even if there is changes in macroeconomic policies.

Systematic risk cannot be reduced by diversification in a portfolio as it affects the economy as a whole. However, one can reduce the systematic risk by choosing the securities with betas that are less than 1 as security’s prices are less volatile and safer to be invested. Another way is through hedging, which is basically insurance for stocks.

Ideal number of stocks to have in a portfolio

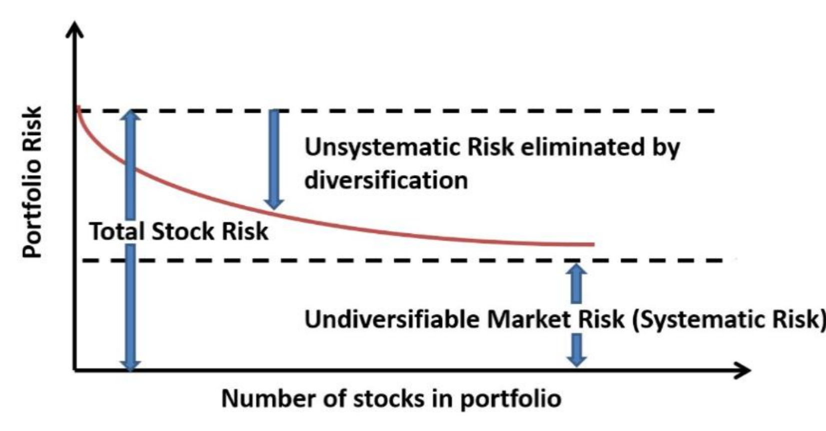

Diagram of portfolio risk against number of stocks in portfolio

Source : http://ordnur.com/academic-study/finance/difference-between-systematic-and-unsystematic-risk/

The graph above has explained well about diversification concept. It may seem like a great idea to have a fully diversified portfolio, but realistically it is the opposite. There may be many hidden costs for us to do so. For example, transaction costs for different types of investments, tax charged for different financial assets, and commission for agents.

There is no perfect answer to the number of investments that we shall hold in order to eliminate unsystematic risk as it all depends how much resources can the investor commit to his/her investments. Too much investments could potentially lead to excessive diversification, where an investor might need to devote and sacrifice a lot of their time to keep track of their investments, which might lead to a decline in performance of their investments.

Conclusion

An investor should always attempt to pursue investments that the investor is familiar with to prevent risking capital losses. One should also thoroughly analyze and understand the nature of the investment before making a decision. Even though diversifying investments is a good way to manage risk, you should make sure to not fall to the realms of illegal investments with the hopes to cover any potential losses,

no matter how high the promised returns are. It is notable that diversification is not purely investing more to offset the risks involved, but choosing wisely on what to further invest on with the hopes of earning higher returns. Otherwise, the gains and losses made by the investments within your diversified portfolio will offset each other or even succumb to major losses in the end.

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