Mastering art of diversification

The first thing most investment advisers or financial experts will tell you is not to keep all your eggs in one basket – diversification is the key to sound investing. Photo: Slightly everything

Island Investor
By Don Freeman

EVERY financial adviser or expert will talk about the need for investment diversification or at least the importance of not putting all your eggs in one basket. Unfortunately, diversification tends to be more of an art rather than an exact science, as some of the so-called tools out there are rather crude. For example subtract your age from 100 to get the percentage you should have in stocks with the rest being in bonds.

Moreover, a well-designed and diversified portfolio (which limits your exposure to risk) is counter-intuitive for most investors, as it will always have something that's not doing well (but will hopefully improve if market conditions suddenly change), a few investments that have an average performance (but could become home-runs) and (it is hoped) one or two investments that are home-runs.

Think beyond stocks and bonds

Diversification is more than just about owning different stocks and bonds – you should also take other asset classes such as gold, commodities, currencies, real estate and foreign equities into consideration. You will also need to take a look at the whole picture (as in your whole net worth).

For example – if most of your net worth is actually tied to the value of your home and the real estate market in your area crashes, so will your net worth, as you were not properly diversified.

Likewise, if most of your investments are concentrated in shares of your employer (or in companies or sectors you are personally familiar because of your profession), you could end up like many employees of Enron who not only lost their jobs, but also just about all of their retirement funds. With that in mind, proper diversification will likely have you owning a REIT or a real estate ETF which invests in various types of real estate in other geographic areas along with stocks, bonds or ETFs in companies or sectors you don't work for or in.

More investments is not necessarily better

If the majority of your net worth is tied up in your home and the real estate market crashes, it could be a financial disaster for you. Photo: Respres

Common sense should tell you that if you hold 10 stocks in your portfolio and one performs poorly or even goes bust, it will have a far bigger impact on your overall performance and net worth than if you held a portfolio of 100 stocks. On the other hand, do you honestly think you are capable of fully understanding 100 different stocks?

So called high-conviction funds or fund managers tend to compromise on diversification by holding portfolios of 20 to 25 stocks which they take the time to thoroughly understand. In fact, there have been a number of research studies which seem to suggest these fund managers are right and that a concentrated, low-turnover investment approach leads to greater returns and less volatility.

Uncertain income and taxes

Many retirees with what they thought were safe pensions (those from the public sector for example) have found out the hard way that the income from such pensions can change and it can change without warning. And it's not just your pension income that you need to worry about because there are many examples of stocks (automakers or the big banks immediately after the financial crisis) cutting or eliminating their dividends or bonds and suspending bond payments (Detroit for example), while interest rates are at near record lows in many developed countries to the point where having US$100,000 in most CDs will yield only a few hundred dollars a year after taxes. Finally, don't forget that some forms of US retirement income are taxable (and tax rates can change) while other types of income may not be depending upon where you live and the accounts holding the investments.

For those reasons, you need to consider all of your income sources in retirement and ensure that you have some sort of income diversification with any pensions, stocks, bonds, real estate and CDs plus tax deferred retirement accounts all being part of the mix. If portfolio diversification sounds overwhelming, call me to discuss simple options to get your portfolio growing.

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Deutsche Bank's new Platinum X range

Retirement Years
By David Mayes

DEUTSCHE Bank has recently revamped its asset management business, re-branding it as DBX and launching a series of new funds.

Several of these are new feeder funds, which allow those with smaller portfolios to access some very good fund managers, and have really caught my attention. I have written on a few occasions about Winton, which has averaged about 15% since its inception in 1993 with only a few down years and each less than 10%. In addition to a low minimum feeder fund for this fund, there are also feeders for Lynx, Tewksbury Trading, amongs others.

On top of this, they have launched two new funds which have a mix of great managers with long consistent track records.

What really excites me about these funds is that I have been restricted for many years from using some of these great managers with the exceptions of my largest portfolios. Now even my smallest portfolios can have access to the kind of managers that I always speak of as the all-stars of Wall Street. Many of these funds have typically had their largest returns in years when the stock market crashes because they are able to take both sides of the market.

With tight risk control and the ability to go short (make bets that the market drops), it is actually easier to make money in bear markets because while it may take many years for a market to gradually climb higher, the panic involved when the bottom falls out allows for an abnormally large percentage move in a very short period of time. Many of these funds trade systematically and completely remove the human element, so that historical probabilities guide decision making as opposed to emotions.

We are now into our fifth year of an advancing stock market while the underlying global economy remains questionable. These kinds of funds may be able to save your portfolio from decimation, if I am right, that we are due for a crash in the global stock markets.

Lynx has averaged about 13% over the last 12 years or so, also with all down years less than 10%. Tewksbury Trading's trend following fund has a very similar steady long term performance despite the world economy going through a once in a lifetime environment. The funds I have just discussed are only one strategy, and there are many others available via the new series. Many other managers are now accessible through the new Deutsche Bank Platinum X line of funds at a fraction of the normal minimum investment levels.

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Deutsche Bank's headquarters in Frankfurt, Germany. Photo: Dontworry