Investment Management: The idea of Diversification

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"Wide diversification is only required when investors do not understand what they are doing." – Warren Buffett

Investopedia defines diversification as a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. It aims to maximize return by investing in different areas that would each react differently to the same event.

So can we diversify all the risk that is there in the investments? If not then what we can diversify and what we cannot?

There are mainly two types of risk: Systematic Risk and Unsystematic Risk.

Systematic risk is also called non-diversifiable or un-diversifiable or market risk. This risk is beyond the control of individual investments, companies or industry. This risk comes with factors like interest rate, inflation rates, exchange rates, and political instability. The concept of systematic risk applies to individual securities as well as to portfolios. The market or systematic risk cannot be diversified and hence it is non-diversifiable risk which investors have to accept.

Unsystematic risk is also called diversifiable risk. It is a risk associated with specific company, industry, market, economy or country. This risk can be reduced through diversification and hence it is diversifiable risk. The most common sources of unsystematic risk are business risk and financial risk. If we invest in various assets then they will not all be affected the same way by market events.

The below example will help us clarifying the impact of Systematic and Unsystematic risk.

There are two software companies. One deals primarily in software services and another with niche product space. Both these companies export

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their products or services to overseas market and earn revenue in American Dollars (USD). Later they get this revenue converted in Indian Rupees (INR). If exchange rates of USD to INR changes with INR getting depreciated then both the companies get more INR revenue without making any business changes while opposite is also true. Here if an investor selects either of this company then the exposure to exchange rate fluctuations, and accordingly an impact on the earning on these companies, will remain the same. This is a systematic or un-diversifiable risk. The risk will not be diversified even if we select either of these companies. Now in another scenario, the product company is developing a software product in the space of Analytics and has made significant investments towards that. This is a business specific risk. If the product is successful then it is huge gains otherwise huge losses. This risk associated only with the product company and not with the market. Hence this risk can be diversified by selecting another company which may not have a similar kind of exposure in the product category.

We are clear that company specific or diversifiable or unsystematic risk can be diversified by allocating investments among various financial instruments, industries and other categories. Now if we have to diversify the risk associated with in a portfolio of multiple stocks then how many stocks can help us diversify this unsystematic risk?

There are several academic studies available to support the idea of number of stocks to diversify the unsystematic risk; however, there is no consensus. One such study is conducted by Frank Reilly and Keith Brown. In their book Investment Analysis and Portfolio Management, they reported that for randomly selected stocks about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks. In other words, if you own about 12 to 18 stocks, you have obtained more than 90% of the benefits of diversification, assuming you own an equally weighted portfolio. There is another study which indicated 30 stocks. Whatever the number, it is significantly less than *all* the stocks in the market.

This set of 12 to 30 stocks will help you removing more than 90% of the unsystematic risk. But you will still have systematic risk remaining in the portfolio of stocks. This systematic risk will give you the same return in the

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market as if you had bought a passive market index. If you want to obtain a higher return than the markets, you increase your chances by being less diversified or have a more concentrated portfolio. At the same time, you also increase your unsystematic risk and thereby total risk. Remember, diversification may help us in protecting the wealth, but concentration will help in building the wealth.

Warren Buffett rightly said that "Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing."

The Author

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