DIVERSIFICATION – BOON OR BANE?

Financial planning expert David Choo says you can't diversify enough, when it comes to investments.

The maxim for investment in property is location, location, location.

The statement that is rapidly becoming a maxim for investments is diversify, diversify, diversify.

The proverb "Don't put all your eggs in one basket" is a graphic way of saying the same thing. But despite many of us intuitively agreeing with the wisdom of diversification, we have at times fallen prey to greed and bank everything we have on one form of investment, be it equities, property or even a business venture. Perhaps, risk takers are driven more by "no venture, no gain" or "high risk, high reward".

The fact is that many don't diversify or don't diversify enough in the areas of wealth protection and investment.

Take the case of a friend who was in the building trade and was doing well. His success led him to purchase five properties, residential and commercial, not only in Singapore but Malaysia as well. When the property slump came, he could not finance his mortgages because he could not find tenants and his own business slumped. He had to surrender his properties to the banks and still owed vast sums to them. He was not alone in putting all his money in property.

Singaporeans have a loving relationship with property, especially when land is scarce and property had been a darling investment for decades. But it is a big investment and one must not be overstretched or over-exposed. Purchasing property in Malaysia may be his way of diversifying, but it

turned out that the Malaysian properties slumped as well at about the same period. From a risk management point of view, Malaysia is too closely linked with Singapore and some potential risks are shared. Ceteris paribus, the safer way to diversify in property investment is to invest further afield to a country which will not be affected by the political fortunes of Singapore, e.g. Australia or Europe, or even America.

WHAT WOULD BE GOOD DIVERSIFICATION?

To answer this, one needs to identify what are the risk exposures diversification seeks to reduce.

Diversification seeks to reduce the following risk exposures:

1. Risks inherent or associated with the different forms of investments, e.g. equities, bonds, unit trusts, property, insurance, etc.

2. Risks arising from economic factors which affect different sectors differently, e.g. technology, finance, infrastructure, agriculture sectors, etc.

3. Risks arising from economic and political factors which affect different countries and regions differently.

4. Risks arising from timing of investments since predictions can be right or wrong.

5. Risks of financial failure or poor performance of the company we depend on, e.g. insurance companies.

6. Risks related to the quality of advice by the financial adviser.

RISKS OF DIFFERENT FORMS OF INVESTMENT

The common way of reflecting this is the risk pyramid with the lowest risks (e.g. savings and fixed deposits) at the bottom and the highest risks (e.g. futures, commodities) at the top.

The important principles to apply in choosing from the different forms of investment are:

1. Know what your risk profile is (tolerance)

2. Know what your risk appetite is (ability to take risks)

3. Know which forms of investment have positive correlation (move up or down together) or negative correlation (move in opposite direction) and the extent of the correlation.

4. Know what your investment objectives are, and select the right form (or combination) of investments.

"Asset allocation" is a term commonly used to describe the allocation of one's investment dollars to the various forms of investment.

Textbooks extol the virtues of asset allocation and how it accounts for the reliable performance of one's investment as compared with "timing the market", which can be dicey.

Asset allocation is an important principle and, when accompanied by regular rebalancing to adjust to the market, it should yield good results. But diversification is more than just asset allocation.

DIFFERENT SECTORS

Equities are a form of investment but the shares of firms in different sectors differ greatly in their risk exposures and risk rewards relationship.

JUST AS IT IS SAFER TO SEEK A SECOND OPINION FOR OUR HEALTH PROBLEMS, IT MAKES SENSE TO CONSULT MORE THAN ONE ADVISER FOR YOUR FINANCIAL HEALTH.

Economic growth may be faster in some sectors within the same country. It is important to explore how risks can be moderated, whether within the country or regionally or globally. Obviously, the risks will be considered better diversified if the investments are in different countries or regions.

ECONOMIC AND POLITICAL RISKS

Putting all your investments in one country, even if you have spread them over a few forms of investment, is not sufficient diversification because of the economic and political risks that the country is exposed to. It is better to invest in more than one country and more than one region in case of political turbulence, war, terrorism or natural disaster. SARS and the recent tsunami are examples of how some countries may be affected more than others.

Investing overseas calls for more homework and may involve some extra costs but the gains in risk diversification are worth it, especially if large investment sums are involved.

TIMING OF INVESTMENTS

Putting all of one's money "one shot" runs the risk of getting it wrong in terms of price movement. A regular investment plan can achieve better results in a market with ups and downs.

"Dollar cost averaging" is a term used to describe how a regular investment plan can achieve better results over the long run. Market timing can yield or kill.

RISK OF FAILURE

Over many years of rapid economic growth, Singaporeans became accustomed to certain returns from their investments. Country club membership used to be a sure investment but no longer. Many have lost money because of the failure of clubs to deliver or to survive.

There are many who have purchased all their insurances from one insurance company with no regard for the danger of losing if the firm fails to deliver. The recent reduction of annual bonus and terminal bonus by most of the firms was a rude shock to many. Today, there is a big difference in the rate of bonus declared by the different insurance companies. Being a "broker" able to transact for many companies, I am often asked to recommend a firm. Without a moment's hesitation, I say that I would have to look into this further but I would definitely not recommend one firm. Rather surprised, they would ask which one and why. My simple answer is that I'd not recommend the firm they have already purchased from because of the wisdom of diversification.

The same goes for unit trusts. It is better to use more than one fund manager, as the performance of each unit trust is largely dependent on the fund managers. For long-term investments like life annuities, which require the insurance firm to pay annuities for long periods of thirty or more years, having two annuities or leaving some of the retirement money with CPF would be a preferred diversification strategy.

QUALITY OF ADVISERS

Just as it is safer to seek a second opinion for our health problems, it makes sense to consult more than one adviser for your financial health. An advice is only as good as the adviser. And there are advisers and there are advisers. Some are relatively inexperienced and only represent one firm (e.g. insurance company). Some have just the minimum certificates to practise while others have gone far ahead in their field.

When advice is still free in the financial services industry, clients should consult more than one adviser. Preferably, one of the advisers should be an independent financial adviser who is able to provide fair and objective advice and provide choices of products from many product providers.

DIVERSIFICATION STRATEGY

A good diversification plan would optimise rewards against risks. "Over-diversification" is not necessarily advantageous if it means drastic reduction of rewards. For investors with modest sums of money, unit trusts may achieve sufficient diversification if the funds are judiciously selected. Investors who are looking for good investment returns often advocate taking some risks with less than ideal diversification. They must go in with their eyes open. Spreading our resources too thin may achieve diversification but may be less effective.

In corporate planning, diversification into many other businesses has been the Waterloo of many corporations which painfully have to hive off non-core business to concentrate again on their core business.

The ideal in investments is to achieve sufficient or optimum diversification. A good adviser can guide the client to build a portfolio of investments to achieve this.

Diversification – boon or bane? It depends on whom you consult and what you invest in. It's in your hands.

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