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Article



Do not put all your eggs in one basket: Diversifying your portfolio is key to maximizing returns and mitigating investment risks

It's no secret that 2022 was a difficult year for financial markets. The combined effects of the Russia-Ukraine war, China's hard Covid lockdowns coupled with the global supply chain constraints, drove global inflation to astronomical levels in 2022, especially in major economies, with the US reaching a 40-year high of 8.6% in May, peaking at 9.1% in June this year. This prompted central banks around the globe to implement aggressive interest rate hikes as a fight against blistering inflation and currency weaknesses.

Financial markets tumbled worldwide as hot inflation and surging interest rates heightened fears of a global recession. The S&P 500 plunged by 20.58% in the first half of the year while the JSE All Share Index dropped 10.16% and the NSX Local Index was 6.90% lower. Markets started showing signs of recovery in October 2022 as the narrative of global slowing in the pace of interest rate hikes inspired some positive equity performance. By end of November 2022, equity markets recovered some of the losses suffered in the first half of the year but remained in a depressed state. The S&P 500 was down 14.39%, while the JSE All Share crawled back in a positive territory recording a return of 1.52% year-to-date and the NSX Local Index was 4.65% down for the same period. Therefore, not much to cheer about in 2022 for the investor who is already under pressure of diminishing purchasing power due to rising inflation and high interest rates.

As the year comes to an end, many investors may be wondering how to better position their investment portfolios for the new year given the significant volatility experienced in 2022. The goal of every investor is to maximize return while minimizing the risk of loss. However, 2022 provided us with a fresh reminder that uncertainty and volatility are features inherent in all capital markets, which makes it difficult to predict which asset class will perform best in a given period. Therefore, investors are faced with the daunting task of finding investments that meet their investment goals.

Although there is no simple formula for achieving every individual or institutional investor's investment goals, several studies have established that the most important decision in creating wealth is deciding upon asset allocation. This is the process of deciding how to distribute an investor's wealth among different countries and asset classes for investment purposes. An asset class is comprised of securities that have similar characteristics, attributes, and risk/return relationships. Traditionally, the main asset classes are equity investments (dividend-earning investments), bonds (interest-earning investments), real estate (rent-earning investments) and cash. For example,

a hypothetical investor with N\$100 000 can decide to construct a portfolio based on an asset allocation of 60% equity, 30% bonds and 10% in money market instruments. The rationale is that diversifying across asset classes should yield better trade-offs between risk and return than investing solely in one single security or asset class. This is because assets perform differently in different periods, and it is difficult to predict which asset will perform best in a given period.

One of the key pillars of asset allocation is diversification. Diversification is a technique that reduces portfolio risk by allocating investments across various asset classes, geographies, industries, and other categories. The underlying principle of diversification rests on the notion that different asset classes and industries offer returns that are not perfectly correlated, hence diversification reduces the overall risk in terms of variability of returns for a given level of expected return.

While asset allocation gives an overarching plan and strategy that defines what portion of your portfolio to invest in different asset classes, diversification involves distributing the investor's wealth across asset classes, sectors, and currencies etc. For example, based on the hypothetical investor described above, if that 60% equity allocation is invested solely in one blue-chip mining company on the Johannesburg Stock Exchange without broad exposure to other sectors (e. g. financials) or regions (e.g., foreign equity), then it lacks diversification and hence could be a high-risk strategy. In an event where the share price of the mining company collapses, the investor will see 60% of his portfolio wiped out overnight. Therefore, diversifying across different asset classes and sectors mitigates this risk because when some assets, industries or companies are falling in value others tend to rise thus offsetting those losses on average across all investments.

Although asset allocation and diversification does not guarantee superior returns, a properly allocated and well-diversified portfolio is more likely to meet the investor's return objectives in different economic circumstances while reducing overall market risk, over the long term. In this respect diversification has been described as "the only free lunch you will get in the investment game".

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