

Reflecting on Risks, Diversification and Asset Allocation

Recently, China Aviation Oil (CAO) shares resumed trading after more than a year of suspension and US\$550 million in trading losses (Source: 27 Mar 06, The Straits Times). Many investors holding on to CAO shares must have breathed a sigh of relief. In its heydays, as many of us could still recall, analysts held positive views of CAO and investors scrambled to get a piece of the action. When we talked to some investors then, we learnt of some holding more than 50% of their portfolio in CAO's shares.

Through this whole episode, we are once again reminded of the risks inherent in investing, and of being overconfident in any single investment. One of the most important investing concepts – the need for diversification – comes to mind. Diversification helps us avoid losses that could put us out of the investing game. Just imagine, to recover a 50% loss, we need to achieve a 100% return just to get back to where we were previously.

There are various degrees of diversification. A portfolio of stocks can diversify away company-specific risks, but if all the stocks are within the same industry, then industry risks are still present. Similarly, a portfolio of stocks in only one country may suffer from country-specific risks. To achieve “true diversification”, the investments should be spread across asset classes, geographic regions as well as industries or sectors.

Over-diversification, however, may result in a sub-optimal portfolio. That is, equal investments into stocks producing positive and negative returns may produce mediocre overall returns. Mismatch in spreading the funds may also result in the required risk/return profile not being achieved. For example, it will be difficult to achieve an annual return of 8% if 90% of a portfolio was invested into SGS bonds in today's environment, since yields on SGS bonds are currently less than 4% (Source: Singapore Government Securities website, www.sgs.gov.sg).

The concept of asset allocation builds on the basic framework of diversification, and brings it one step further. It is about creating a mix of asset classes to deliver the returns to meet goals, taking into account risk tolerance and time horizon. Asset allocation helps to answer the question of what to invest in and how much. In times of market downturn, assets can even be shifted into safer instruments such as money market funds. In PMA, the concept of asset allocation forms one of the key principles of our investment decision-making process.