HEATHCOTE
INVESTMENT PARTNERS

DIVERSIFYING THE WINNING GAME

"*Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing"*
Warren Buffett

Diversification is as important to investing, as the All Black Coach Selection is to New Zealand's chances of winning future Rugby World Cups. Diversification remains a central element of Markowitz's Modern Portfolio Theory involving the immunisation of a rational investor's portfolio against non-systematic risk. It has also provided a delightful safe-haven for those financial advisors who advocate a buy and hold strategy - disguising the reality that diversification protects their fees on depreciating portfolios during down markets.

More recently challenges against the theory of diversification have increased by notable investors such as Warren Buffett, compelling more investors to seek professional financial advice. These investors are often greeted by an uninformed advisory community who are set about recommending dispersed portfolios that have little consideration for essential tenets of portfolio construction including efficient frontiers, correlation, or standard deviation of returns. These portfolios are, in many instances, a confused blend of investment management styles and beliefs that serve to erode a great deal of the investor's future net worth and purchasing power. In some cases, portfolios are structurally flawed from the outset, due to fund limitations, or the failure of proprietary platforms to carry more diverse funds.

In recent years, many of the major indices that sit behind traditional investment styles have delivered a negative return on an inflation adjusted basis. As these are the foundation that many of the professional money managers peg their portfolios against, the net result is a further erosion of an investor's net worth. Even in today's tumultuous markets, many financial advisors argue that "time in versus timing" will provide the magic tonic returning everything to what it once was.

The argument for diversification makes as much sense as Graham Henry assembling the new All Black squad out of the elite players, mediocre players, and those who are physically challenged – just so he can claim that he has a diversified team. And yet the financial advisory industry continues to encourage investors to do exactly that with their portfolios.

So what is the alternative for those investors who don't have the time or inclination to do the proper research, and wish to avoid exposing themselves to an ineffectual financial advisor? Index funds

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remain the easiest, cheapest and most thorough vehicle to provide investment diversity. Over a long period of time the average return should be about 11% per year, which is what the market does anyway – although index funds won't eliminate systematic risk. They will also save the investor a ton of fees/commissions along the way (as opposed to buying several types of asset classes and individual investments in each class). An unfortunate consequence of the index-approach is that there is really no strong requirement for the investor to pay for on-going financial advice.

Perhaps the best solution is for financial advisors to assemble blended portfolios comprising of index funds (for which they deserve no on-going advisory fee) and alpha-focussed investments that are managed by investment personnel who are motivated by delivering what they said they would, and contain appropriate safeguards to protect the downside. Assuming that the financial advisor has adequately understood the investor's risk and return expectations, then they should also be compensated for their competence. In the eyes of most investors, financial advisors are paid to determine whether markets will go up or down, and select the appropriate investment solutions - not to waffle on like a one-eyed-arm-chair rugby commentator.