Portfolio Diversification (Week 5)

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In investment finance, the topic of portfolio diversification cannot be emphasized enough. Any investment decision was undertaken bears risk and investors are often interested in how they can minimize it. Portfolio diversification offers an opportunity for investors to lower the risk of investment while maximizing the benefits. Following up on week three, the paper will look at particular topics that would be addressed along with a list of critical points, and facts from supporting sources.

Diversification can be based on industry, company size, geographic location, and asset type. Understanding risk in investment, reasons for portfolio diversification, and shortcomings of portfolio diversification, optimal diversification, and portfolio rebalancing are the three major topics that would be looked.

List of key points

1. Understanding risk in investment

   a) Scenarios of risk-risk of losing money, price volatility, and wrong decision making

2. Reasons for portfolio diversification

   a) Minimization of risk

   b) Offering more opportunities

   c) Application of different investment styles and

   d) Limits domestic country bias

3. Shortcomings of portfolio diversification

   a) Increased risks in over diversification

   b) Time-consuming portfolio management

   c) Unattained diversification goal

4. Optimal diversification\

    a) Naive and sophisticated diversification (Bayesian theory)

5. Portfolio rebalancing

    a) Rebalancing strategies

    b) Cost of rebalancing

Understanding risk

To understand the issue of risk in investment, it is necessary to look at some of the possible scenarios that amount to uncertainties including the risk of losing money, price volatility, and wrong decision making. Risk measurement thus is a vital factor of consideration when choosing between given investment vehicles.

Reasons for portfolio diversification

The main reason behind portfolio diversification is the minimization of risks. According to Ross, Jaffe, and Jordan (2009), portfolio diversification is a like a safety net where an investor seeks to prevent their entire portfolio from losing value. Investors are better placed to attain their long-term financial goals through diversification. With investments spread in various stocks, an investor is better placed to face different economic downturns. Other reasons for diversification include offering more opportunities, room for application of different investment styles, and limits chances of local country bias. Abid et al. (2014) assert that whether one opts to go for local or global diversification, the benefits accrued to him/her are more or less the same with the only significant risk being how large or small the risk involved is. Most internationally diversified portfolios stochastically dominate domestic ones (Mroua, Abid, & Wong, 2017). At a low risk,

international diversification stands to be better than domestic diversification while there is no preference at equal risk levels (Abid et al., 2014).

Shortcomings of portfolio diversification

While diversification has its upside, it also has its downside. In the quest to diversify his/her investments, an investor may end up purchasing more risky investments that they do not understand. Ross, Jaffe, and Jordan (2009) point out that diversified portfolios may be time-consuming with regards to management and the purpose of diversification may not be attained.

Optimal diversification

When it comes to optimal diversification both domestic and international factors are put into consideration. In assessing the financial risk involved in the outcome of given portfolio performance, the Bayesian theory is applied. Robust portfolio application rules are used to estimate the error involved. According to DeMiguel, Garlappi, and Uppal (2007), portfolio rules are laid down to help in attaining optimal returns from risky assets. Although optimal diversification is ideal, it may be difficult to attain since it is largely dependent on the correlations between given investment vehicles (Abid et al., 2014). Optimal diversification is complicated, and more often than not, investors would prefer to go for 'naïve' diversification which does not involve a lot of mathematical computations of risk and errors mainly relying on past performance information and instincts. DeMiguel, Garlappi, and Uppal (2007) in their theory of "Optimal versus Naïve Diversification: How efficient if the I/N portfolio strategy," found that basic diversification models give rise to better results than sophisticated models about statistical significance. Oversimplified diversifications may not be as effective, but neither are sophisticated ones. Optimal diversification thus aims at minimizing risk more than increasing returns.

Portfolio rebalancing

A given portfolio should be capable of being restructured to take advantage of the prevailing investment changes. Portfolio's asset allocation determines portfolio's risk-and-return. Rebalancing refers to selling and purchasing part of the portfolio to lower the risks (Jaconetti, Kinniry, & Zilbering, 2010). A given diversified portfolio may be optimal now but ceases to be as such when there are changes in assets markets. While investors may be interested in maximizing returns, a rebalance undertaken to minimize risks as opposed to increasing investment returns, Rebalancing may, however, add value to a previously constructed portfolio (Qian, 2012). Various rebalancing strategies exist including monthly, quarterly, semiannually, and annually. Jaconetti, Kinniry, & Zilbering, (2010) observe that investors choose a rebalancing strategy based on their willingness to accept risk against anticipated returns. Anticipated returns are net of cost of rebalancing which includes taxes, time, and labor (Jaconetti, Kinniry, & Zilbering, 2010).

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