Investments: Diversification

Are You Diversifying Enough?

By: Joe the Investor

If you read most material about investing, one of the cardinal rules is “don’t put all of your eggs in one basket”, or “diversify your holdings”.(1) The idea behind this advice is that if you put money into various types of investments, and one of them goes down, the others may go up, giving you a more consistent or less volatile return over time. The assumptions behind this are that the investments you are buying are actually different, and will offset each other in all market environments. The investments referred to in most literature is usually stocks and bonds, and maybe real estate, but does this cover all possible means of creating wealth? What issues are there with this strategy? Diversification in a traditional sense works 99% of the time, but that 1% is becoming more prominent, and conventional methods may not be effective in preventing losses.

The idea of diversification is dependent upon: 1) the balance between buy and sell orders, 2) how much interconnectedness exists within the markets in question and 3) the systematic factor of issuing money combined with leverage which may override the ability of the buyer and seller (or the market) to agree on prices.

1.

In a balanced market, there will always be someone to complete a buy or sell transaction. If nobody wants the investment you are selling, you would have to lower the price, but the transaction would still be completed at a stable price. If people really don’t want it, you wouldn’t be able to sell it at all, and you would not be able to complete the transaction – meaning your investment would have no value at that time. This phenomenon happens when a market crashes – everyone wants to sell their positions at once, and nobody is buying, so prices fall very fast. The market in this case would be imbalanced, and diversification would only reduce volatility outside of this imbalanced market.

2.

Interconnectedness is how connected markets are to each other. This idea can be understood starting with the local investing environment. If you buy only Canadian bonds, they would all be affected by similar factors – Canadian interest rates, Canadian political climate, the Canadian economy, and regulation. If you buy Canadian stocks and Canadian bonds, there are factors that affect them both, but not in the same way. For example, higher interest rates directly affect bonds since interest rates drive the bond price by the law of compounding and the law of arbitrage (the markets will adjust the price of something until all of the possible instruments

carry the same or an equivalent price). If you then buy Canadian and American stocks and bonds, common factors will be fewer still. As you buy more global investments, the common ground becomes less and less, as some economies will boom and others will bust. The economic cycle, interest rate, currencies, consumer spending patterns, trade and regulation will be so different in each country that you can have investments that move in opposite directions most of the time. The differences in the market climates are why diversification works.
Now what if all of the world economies were connected? What if all of the interest rates in the world are linked to each other? What if all the economies were to boom at the same time and bust at the same time? Would diversification make a difference? All of the different stocks you own would behave as ONE. Even the world bond market would behave as ONE if all of the underlying drivers moved in tandem. If there was a scenario where people were selling anything out of fear – anything and everything would go down at the same time. Does this interconnectedness exist? Did the Eurozone crisis of 2011 affect our portfolios in Canada? Did this crisis affect China, Japan, Brazil, Russia? What about the bond market in Iceland, or a bank in Ireland? All of these events affected our portfolios. How? Due to technology, the coupling of the world economies through trade deals, world sharing of labour through outsourcing, commodity prices that are uniform throughout the world, and derivatives that can be traded anywhere and affect anything. Since derivatives can be linked to any investment, counterparty risk, or the risk that the parties involved will pay for their bets, plays a large role in linking markets together. As an example, if you have a sound bank in Europe, and it invests in bad American mortgages, this bank will get affected in the same way as American banks have been hit even though the European bank operation itself has not changed. Does 2008 ring any bells of familiarity? So if the world is one giant economy, what can diversification do? In a "normal market" which is where buying and selling forces are balanced, or prices are not moving too quickly up or down, diversification is effective. If you want to sell, you can get a stable price. The same will happen if you want to buy. There would be enough differences in opinion to make the market function. If everyone is fearful and the market is unbalanced – this will not be the case.

3.

The third assumption is the issuance of money combined with the use of leverage. As a hypothetical example, if there were 1 million shares of a small mining company that existed, and these shares were valued at $2 each, the total value of the shares traded would be $2 million dollars. If someone with $10 million starts buying the shares, and intends to spend the whole $10 million, what would happen? The share prices would rise. Not only that, if every single shareholder sold their shares to this one person, this person can dictate the price by himself. If he wanted to pay $5 per share, the shares would trade at $5 per share. If he wanted $10 per share, the shares would trade at $10. Suppose that only a small fraction of the original shareholders actually did sell. If 100,000 shares got sold, and the price was $10, only $1 million would be spent. This person still has $9 million to spend. If the original shareholders continued to hang on for further price increases, the remaining $9 million can continue pushing prices up. From the original $1 per share, prices can be pushed up to many times that value, strictly because "a lot of money is chasing a fixed number of shares". Notice that there are no other factors being considered for the determination of the stock price, such as: the industry, the economy, fundamentals of the company, management, regulation – not even technical indicators like price history or price-volume indicators. The price goes up simply because there is a ton of money buying the shares. This is how those “pump and dump” schemes work. The difference is that there is no aggressive selling tactic used to get people to buy shares, and no sudden withdrawal of the speculators’ capital which causes the subsequent crash.

What is the point of this story? If you look at the entire stock market and where money comes from, you will see a similar story. The Federal Reserve and the European Central Bank are “printing money” or issuing a lot of new debt. All of that new debt goes somewhere into the financial system, otherwise it would not really be issued. If you issue $1 trillion and it goes to the stock market, what will happen to stock prices? Since this amount of money is so large, it will dwarf all of the other indicators and cause prices to go up simply because a ton of money is chasing the stocks. This works in any market, including bonds, commodities and derivatives, and would also work in reverse – if similar amounts of money are withdrawn from a market. When money is issued by these central banks, this is leveraged many times the original amount so that the impact is much greater than what the numbers indicate. As an example, if $1 trillion of new money was issued as new debt, the leverage could create $10 trillion worth of new derivatives positions. The estimated size of the derivatives market is $700 TRILLION as of June 2011 (2) (3). As a comparison, the size of the world equity market is about $50 trillion as of April 2011 (5), the bond market is about $90 trillion as of December 2010 (4), and the world GDP is $60 trillion (2). This means derivatives can have a big impact on the other markets and direct which way the prices go – in the same way as in the stock example above. If you remember the stock story above, the quote was “a lot of money is chasing a fixed number of shares”. These two scenarios are parallel because the phenomenon is the same.

Solutions:

Given this backdrop, what should someone do? The traditional means of diversification should still be used, but taken further. In the beginning most people bought bonds, then Canadian stocks, US stocks, global stocks, followed by global debt, commodities and derivatives. It is best to buy a combination of these securities that don’t have a high correlation, or don’t react in the same way to market events. But if all of these instruments are linked together, where do you diversify to next? The key to getting the most out of diversification in the past is to keep expanding your opportunity set to include more exotic investments. The irony today is that the way to diversify further is to get back to basics. Why? The basics are not as interconnected as the traditional investments, and if something extreme happens, the basics will always be sought for or consumed. What are the basics? Holding some cash would be the first one. It does not go up or down with market movements, unless there is large inflation or the currency value is changed through devaluation or some other adjustment. Holding cash also allows you to buy something when it goes down quickly, which reduces your risk versus buying it at a higher price. The next idea is holding other forms of cash – gold and silver are the world’s currency. These used to be used as formal currency, and this can happen again in the future. You can invest in these through gold shares and physical metal. If you have the sophistication and the money, buying property that has multiple uses may be worth exploring – for renting, energy generation, growing food or future development.

The next question to ask is "what does money buy?" and "why do I need it?" If you get goods directly, you don't really need money. This is where barter and creating goods yourself can be considered. An extension of this idea is community barter, currency and localizing production any time you can. This is creating goods directly as a team rather than doing it yourself. Anything can be used as a currency as long as it meets the rules of exchange – it stores value, it is consistent, easily accessible, standardized, and believed to be valuable by everyone using it. An extension of this idea may be start a business of some kind and create a network of people to trade with. The future of diversification will be based on creativity and having an economy that would allow people to create and prosper. Diversification is a good idea, but should be taken even further to ensure it is effective in as many environments as possible.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**

Sources:

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