Diversification, the simple solution to contain portfolio volatility

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We are just two months into 2020 but quite a few equity market participants are feeling like it has been a long time owing to the volatility we have seen in the recent past. A month back if you looked at any market report and equity outlook for 2020, none of them could have possibly mentioned anything about Corona virus; And yet, within a month, the spread of the virus and fear around it has brought global trade to a near halt impacting equities across the world. The virus is affecting industrial activity in China. Global airlines have suspended service to and out of China, hurting the travel and tourism industry. Quarantines and store closures are affecting the retail sector. The Chinese consumer is an important source of demand for a range of products, including cosmetics, luxury goods and the like.

Whether the event qualifies as a 'Black Swan' event or not, only time will be able to tell. One thing is certain, that in an interconnected world, volatility can come from any source and practically any corner of the world. Investors in developed markets have faced this challenge and as our economy is getting more integrated into the global economy, we are also witnessing the same. Our markets have reacted sharply to the developments that are beyond our shores.

Over the years industry experts in the developed markets have worked towards tackling volatility in portfolios. The simple solution to contain portfolio volatility is to have a portfolio with exposure to as many uncorrelated asset classes as possible at an overall level. Diversification can help bring down the volatility at the portfolio level. What a true diversification warrants is not only exposure to many asset classes like equity, fixed income, currency, gold, other commodities, real estate, art etc but also diversification within the asset class. Having four equity schemes all invested in our domestic market is not a diversification in the true sense. Investors will have to look at options having exposure to global equities as well as have a low overlap of the holdings across the schemes. On the fixed income side majority of the investors have focussed on credit/accrual strategies. Recent experience has shown us that a portfolio needs a healthy mix of duration as well as credit strategies. Of-course, time frame and risk appetite are key considerations. The idea is that different asset classes as well as different strategies within the asset class will do well at different points of time. The net effect at the portfolio level will be that the volatility will be significantly lower making the journey much smoother.

It may look simple but in reality it could be a difficult task to manage allocations across uncorrelated assets. In my opinion to construct a truly diversified portfolio customised to individual requirements, one needs a good advisor. Personally I have an advisor and would recommend having one. In the wealth creation journey, a qualified, experienced and unbiased advisor is important. Like many other global events, this too shall pass. Wealth creation over a long term will be determined by the investors ability to stick to the asset allocation that is sufficiently diversified through the cycles.

The only real important task that an investor should focus on therefore is in selecting his or her financial advisor. If you already have one, simply review your asset allocation towards your goals.

Happy investing

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