Barratt
&Cooke
INVESTING SINCE 1880

The importance of diversification in long-term investing

Introduction

Diversification is one of the most fundamental principles in investing. Indeed, while our core focus as investment managers is on constructing portfolios of high-quality, cash-generative and well-managed companies where we believe that the long-term prospects are attractive, we are careful to ensure that portfolios are adequately 'diversified', being positioned across different areas of the market in order to maximise returns and, ultimately, protect our clients.

Diversification is often misunderstood and, indeed, often overlooked as a consideration in investing. In this report, we examine why we believe diversification within portfolios is important for maximising long-term returns, and how this can be achieved from a portfolio construction perspective.

"Don't put all your eggs in one basket"

All investments – even those traditionally considered 'safe', such as UK gilts and investment grade corporate bonds – carry a degree of risk. Broadly speaking, this risk can be broken down into "systematic risk" (i.e. risk that affects the whole of the financial system) or "unsystematic risk" (i.e. risk that affects a single company or a handful of closely related companies).

Systematic risk

Economic recessions
High inflation
Political risk
Natural disasters

Unsystematic risk

Company results or trading updates
Changes in company management
Company mergers and takeovers
Investor sentiment due to external factors (e.g. an unfavourable news story)

Because systematic risks affect the whole financial system, these risks often cannot be avoided. However, because unsystematic risk often tends to be specific to a company, an investor can mitigate this by 'spreading' their investment across different companies.

Consider, for example, an investor who only holds shares in a single company, ABC plc; if ABC has a poor year and their share price falls by 20%, the value of the investor's portfolio will fall by 20%. However, if the investor instead splits their portfolio equally between ABC and XYZ plc, and XYZ's share price rises by 10% over the same period, the portfolio overall will only fall by 10%. Here, the investor has offset some of the downside risk associated with ABC by holding spreading their investment between the two companies.

This effect is captured by the famous adage quoted above, which effectively lies at the heart of what diversification is all about. While systematic risk cannot be diversified away, when an investor "diversifies" their portfolio, rather than "putting all of their eggs in one basket" by investing in a single investment (or perhaps a very small handful of investments), they are seeking to 'spread' the abovementioned risks across a portfolio comprised of a number of investments. This is known as 'diversification'.

Broadly speaking, a portfolio can be diversified in the following ways:

Diversifying by sector – investing in companies that operate across different sectors where we would expect the correlation between returns to be low.

Diversifying by geography – holdings companies listed in different countries so that the portfolio is not exposed to the systemic risks associated with a single country.

Diversifying by asset class – as we have seen in the example above, investing in a range of asset classes (such as equities, bonds, infrastructure, real estate and private equity) whose expected returns are not correlated with each other.

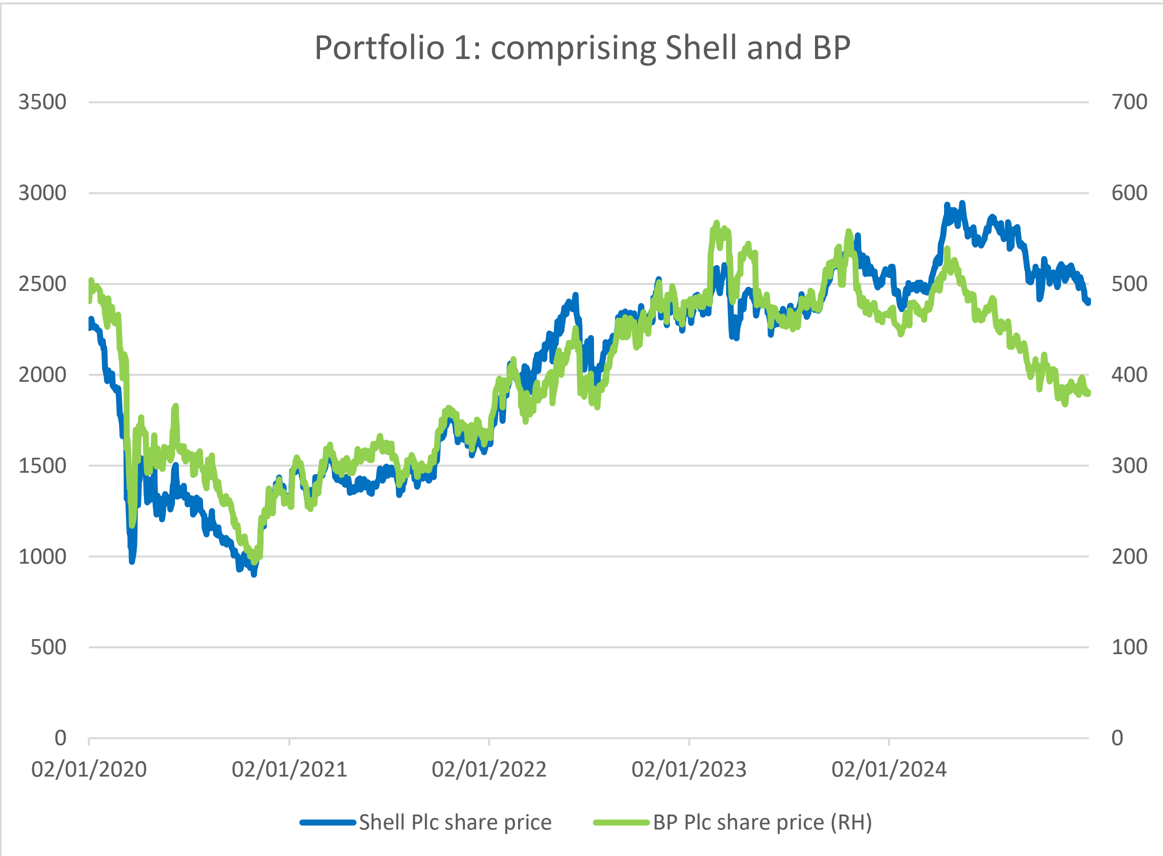
Modern portfolio theory – a tale of two companies

Although diversification is a relatively simple concept, as a core principle in investing, it has received much attention among academics and investors alike. A seminal contribution to the theory of diversification came from Harry Markowitz in 1952, who constructed a model for assessing the risk and return characteristics of a portfolio of two stocks which came to be known as 'Modern Portfolio Theory', an area of finance that continues to thrive today. Broadly speaking, Markowitz argued that in a simple two-stock portfolio, investors could achieve optimal risk-adjusted returns (i.e. returns divided by the 'variance', or volatility, in returns) by choosing an optimal mix of "high risk, high return" and "low risk, low return" stocks. Using Markowitz's model, an investor can construct a portfolio of two companies that maximises expected returns for a given level of acceptable risk.

Since Markowitz's work, many have sought to empirically assess Modern Portfolio Theory and how diversification should be implemented within portfolios. As you would expect, different studies have reached varying conclusions on the optimal level of diversification in portfolios. For example, in their 1970 paper *'Some Studies of Variability of Returns on Investment in Common Stocks'*, Laurence Fisher and James H. Lorie found that a portfolio of 32 stocks reduced the distribution of portfolio returns by 95% compared to an equal-weighted portfolio of companies listed on the New York Stock Exchange.

While there is therefore no consensus on exactly 'how diversified' a portfolio should be, it is generally accepted that to adequately diversify risk, investors should seek to construct a portfolio of stocks whose estimated long-term returns are expected to have a low correlation with each other.

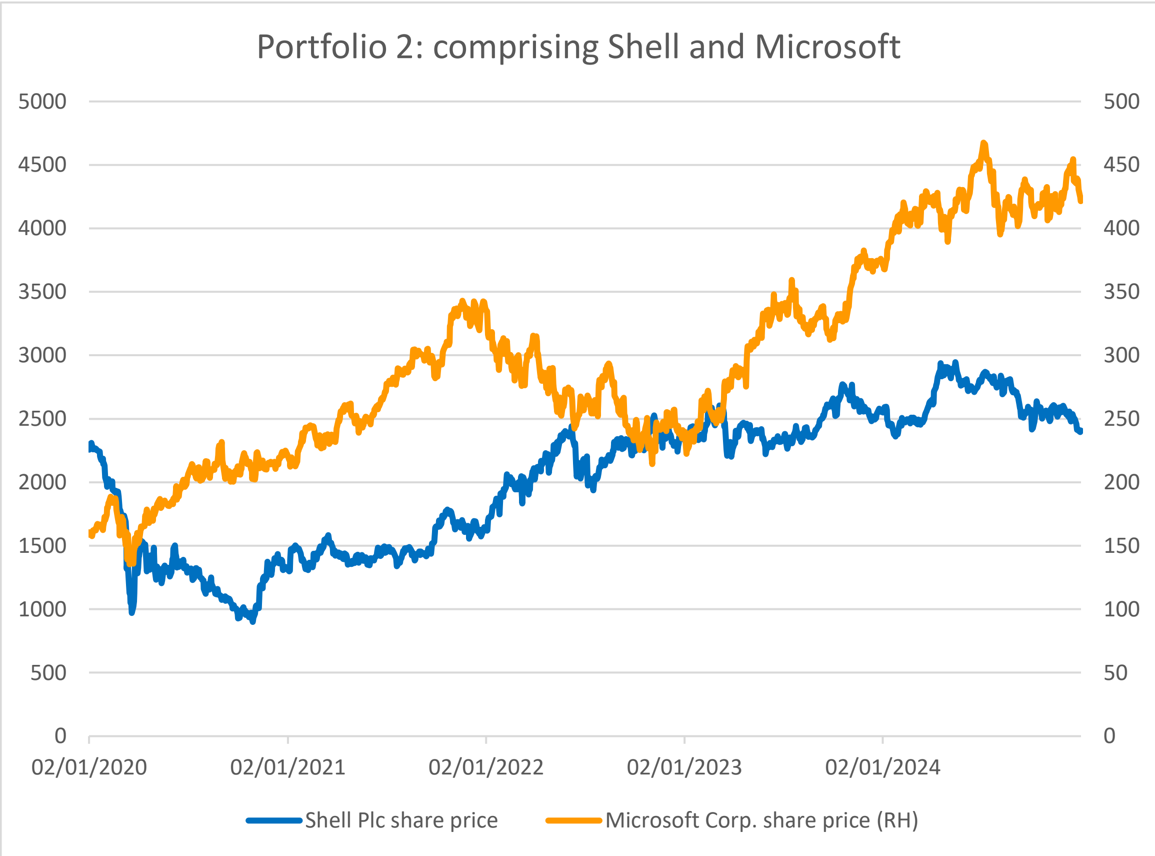
Consider, for example, a portfolio of two real-life companies: Shell and BP. Both of these companies are listed on the London Stock Exchange and both operate in the 'Oil & Gas' sector (though, of course, the exact nature of their operations and structure differ). As you can see from the chart below, looking at the last five years, these companies' share price movements are highly correlated, moving broadly in line with other.



Source: Iress

This is hardly surprising given that these companies operate in the same sector and will therefore be beholden to similar factors influencing their share prices (for example, volatility in oil prices, geopolitical risks and changing consumer demand for oil products such as petroleum). As a result, if an investor held a portfolio of just these two companies (or, indeed, a portfolio of many companies, but where a large proportion of the portfolio was invested in these two), we would expect the portfolio to be more volatile in the long-term, as the overall performance and volatility of the portfolio would be weighted towards these two companies. While this may be beneficial in times when the oil sector performs well, in times when the sector is struggling, we would expect the portfolio to be significantly adversely affected.

Consider instead an alternative portfolio of two companies: Shell and Microsoft. Here we can see in the chart below, that returns are more divergent over the same time period. Again, this is unsurprising as these companies operate in completely different sectors and, are listed in different countries, meaning they are exposed to different systematic risks (such as political risk). Their share price movements are therefore less interlinked, meaning that if one company experiences a fall in their share price due to a specific issue relating to that company, we would expect this to have a minimal effect (if any) on the share price of the other company. This would hopefully serve to moderate the overall effect of the fall in the first company's share price on the performance of the overall portfolio.



Source: Iress

Diversification and portfolio returns

Warren Buffett once famously described diversification as “the price of ignorance”, arguing that the benefits of owning a small, high-conviction portfolio of companies will produce better returns than a large portfolio of ‘blue-chips’. While we would agree that bottom-up stock selection, focusing on the quality characteristics exhibited by companies, should (and, at Barratt & Cooke, does) lie at the core of portfolio construction, for the reasons outlined above, we believe that ensuring that portfolios are adequately diversified is essential to protecting long-term returns and avoiding unnecessary stock-specific risk.

To help illustrate this, consider a simple hypothetical portfolio of companies selected from Barratt & Cooke’s ‘Buy List’, starting with a 1-stock portfolio and increasing the number of companies until we reach a 35-stock portfolio. The model includes a mix of UK and overseas companies and assumes that each company has an equal weighting in the portfolio. As this is for illustrative purposes only, we have ignored factors such as sector, risk tolerance and investment objective.

In theory, a rational investor would want to maximise their “risk-adjusted” return, as they would want to achieve the highest level of return from their portfolio without incurring an excessive level of investment risk. Therefore, for each portfolio, we have calculated the five-year total return, as well as an “adjusted” total return, where we have divided the total return figure by the five-year standard deviation (i.e. volatility) in share prices, effectively penalising returns for excessive risk.

Portfolio	Five-year total return	Five-year ‘risk-adjusted’ return
1 Stock	59.6%	17.1%
5 Stock	109.7%	136.2%
10 Stock	63.3%	177.3%
25 Stock	78.8%	144.1%
35 Stock	76.9%	203.9%

Source: Iress

Of course, this is a very simplistic model which ignores many of the key factors that influence the investment decision (including client-specific factors such as investment objective and risk profile). However, this basic model helps to illustrate the effect that increasing the level of diversification can have on long-term returns.

Firstly, consider the simple five-year total return for each portfolio. Compared to a portfolio of just one company, which has generated a total return of 59.6% over the last five years, a larger portfolio produces higher total returns over the five-year period in question.

More important, though, is the five-year total return where we have adjusted returns for risk (i.e. dividing the total return of each holding by the standard deviation in share price over the five-year period). When we consider the ‘1 stock’ portfolio, adjusting for risk over the five-year period significantly reduces the five-year total return of the holding to 17.1% as the portfolio is highly exposed to volatility in the share price of this single company. However, as we add more companies to the portfolio, we see returns increase well in excess of the ‘1 stock’ portfolio.

While this is a very crude analysis, many much more robust studies have also shown diversification to be key to portfolio performance, both in terms of maximising returns and minimising risk. In their seminal 1986 paper *‘Determinants of Portfolio Performance’*, Gary Brinson, L. Randolph Hood and Gilbert Beebower find that across 91 US pension plans between 1974 and 1983, asset allocation was responsible for the vast majority of a diversified portfolio’s return patterns over time, as opposed to factors such as market timing or stock selection. A more recent study by Vanguard Asset Management found that, over time, most of the volatility in returns in a broadly diversified portfolio was due to underlying asset allocation, while factors like market timing had a relatively minimal impact on return over time.

Of course, more recently, we have seen a prime example of concentration in global stockmarkets with the so-called ‘Magnificent 7’, a handful of US mega-cap tech companies whose exposure to artificial intelligence (AI) has made them key drivers of stockmarket performance over the last 24 months. Indeed, these companies (Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla) have delivered a combined 5-year total return of approximately 532.1% as at 31st December 2024, and now account for over a third of the S&P 500 Index. While this short-term performance is clearly impressive, a portfolio invested in just these seven companies would be highly exposed to stock- and sector-specific risks associated with this area of the market (perhaps best demonstrated by Nvidia, whose share price fell by 17% in a single day in January following the announcement that a Chinese hedge fund had developed a competing AI model).

In addition, such a strategy would expose an investor to wider risks associated with being invested solely in US-listed companies (for example, risks relating to trade tariffs or changes in regulations). We therefore believe that, while concentrated portfolios of outperforming stocks may deliver attractive returns in the short-term, this will come at the expense of a greater level of share price volatility in the long-term.

Achieving diversification within Barratt & Cooke portfolios

At Barratt & Cooke, portfolio diversification forms a key part of our investment process. A typical portfolio within our Bespoke Portfolio Service will hold 35-50 holdings (depending, of course, on clients' individual circumstances), with the equity element of the portfolio providing exposure to a range of both cyclical and defensive sectors as outlined below.

Cyclical sectors		Defensive sectors	
Sector example	**Company example**	**Sector example**	**Company example**
Consumer Discretionary	L'Oreal	Consumer Staples	Unilever
	LVMH		Procter & Gamble
Industrials	Halma	Healthcare & Pharmaceuticals	Novo-Nordisk
	Spirax Group		AstraZeneca
Software & Technology	Microsoft	Utilities	National Grid
	Alphabet		
Resources	Rio Tinto		
	Shell		

Our allocation to equities includes UK equities (predominantly large caps, but with some exposure to mid-cap and AIM companies where appropriate), as well as overseas equities (mainly American and European companies) and some exposure to emerging markets. Where appropriate, as well as owning shares directly, we will make use of 'collective investment' vehicles (such as investment trusts, unit trusts and open-ended investment companies) to gain diversified exposure, particularly for more specialist areas of the market (such as emerging markets, which includes companies based in countries such as China and India) where we can benefit from the expertise of external managers.

While our managed portfolios are typically equity focused, subject to clients' individual circumstances, we add further diversification by gaining exposure to other asset classes whose long-term returns tend to be uncorrelated with equities and where the risk characteristics are inherently different. These sectors include:

- Fixed income investments (e.g. UK gilts and corporate bonds)
- Infrastructure
- Private equity
- Real estate
- Gold

For many of our clients, our Fund Portfolio Service also provides a cost-effective means of achieving an adequate level of diversification. Each of our WS Opie Street Funds is a “fund of funds”, which is invested in a range of collective investments, providing investors with exposure to a range of asset classes, sectors and geographies. This is particularly beneficial to clients with portfolios less than £400,000, where it can be difficult to construct a diversified portfolio in a cost-effective manner. If you would be interested in learning more about our Fund Portfolio Service, please contact your investment manager at Barratt & Cooke.

Tax – “Wagging the investment dog’s tail”

A potential barrier to maintaining adequate diversification in portfolios can often be capital gains tax (CGT). Many investors, particularly those who have been invested for a long time, will have seen the value of holdings that have performed well rise significantly, locking in large capital gains over time. From a risk management perspective, we would typically look to ‘top-slice’ larger holdings such as these, taking some profit on these holdings and looking to invest elsewhere to ensure that the portfolio’s performance is not overly reliant on the fortunes of any one company.

However, with CGT allowances at record lows, it is becoming more difficult to reduce larger holdings without incurring a potential CGT liability. This can be a particular challenge for trusts, which have half the CGT allowance of individuals (£1,500 for the 2024/25 tax year, effectively nil in the context of a large bespoke investment portfolio). While CGT liabilities are clearly unfavourable, it is our view that, from a risk management perspective, paying some CGT in order to reduce overweight holdings and improve portfolio diversification can often be a more sensible option than simply retaining a large holding and exposing the portfolio to unsystematic risk.

We are, of course, conscious that CGT rates have increased in the recent Budget (from 10% to 18% for Basic Rate taxpayers, and from 20% to 24% for Higher Rate taxpayers). However, our belief remains that in order to achieve attractive long-term returns and appropriately manage stock-specific risk, it is better to pay CGT in order to reduce ‘overweight’ holdings than to allow pregnant gains within portfolios to persist (though, of course, capital losses can be used to our advantage to offset such gains). We do and will continue to highlight any overweight holdings that are tied in by CGT upon reviewing client portfolios, and if you would like to discuss paying some CGT in order to reduce such holdings and improve the diversification , please contact your investment manager at Barratt & Cooke.

Conclusion

For the reasons outlined above, we feel that it is appropriate to ensure that client portfolios remain diversified across a range of sectors, geographies and asset classes in order to maximise long-term returns and manage portfolio risk. From a portfolio management perspective, this is incorporated into the initial portfolio construction at the beginning of the client relationship, as well as our annual reviews of managed portfolios. Indeed, as part of our ongoing commitment to ensure that portfolios remain suitably positioned for our clients, we will deal where appropriate to ensure a sufficient level of diversification in the portfolio, as well as highlighting ‘overweight’ positions to clients.

Of course, if you have any questions regarding the information contained in this report, please contact your investment manager at Barratt & Cooke.

Authored by Nicholas Burrows

Important information

Investment involves risk. The value of investments and income from them can go down as well as up and investors may not get back the amount originally invested.

This document:

- Is categorised as a Financial Promotion (as defined by the FCA).
- Has been prepared for use by Retail Clients (as defined by the FCA).
- When considered in isolation, has no regard for the specific investment objectives, financial situation or needs of any specific investor.
- Is for information only and does not constitute an offer to provide services or to purchase or sell investments or related financial instruments.

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