Do we have consistent views on diversification?

Diversification – that a portfolio of distinct opportunities has lower volatility than its individual components - is probably the only genuine *free lunch* in finance. That said, investors seem to have very different attitudes to diversification across various parts of their portfolio.

In defensive portfolios, investors seek high levels of diversification – typical fixed income portfolios consist of hundreds of separate positons (on the surface highly diversified). At a total fund level, this might mean that if a fixed income manager has a 3% allocation (as a percentage of the total fund) and the largest non-government security within the fund is say 2%, this implies a fund-level exposure of only 6 basis points.

By contrast, return seeking parts of portfolio are much more concentrated. On the listed side, an example is the banks – four highly correlated and reasonably volatile companies that represent 25% of the benchmark and 5-6% of total assets for a typical fund. Within infrastructure equity, it is not uncommon for a fund to invest 1% of total assets in a single infrastructure equity investment.

Why does it make sense to hold a 1 or 2% of total assets exposure in the equity of a project – while at the same time limiting exposure to defensives to only 6 basis points? In short it probably doesn't.

But here are some of the reasons why it happens:

- ***Manager vs asset level risk analysis***. Portfolio/manager configurations are exercises in risk management. For some parts of the portfolio – for example, managers in the listed asset classes, the manager is seen as the unit of risk. Manager risk is then managed by splitting each asset class amongst multiple managers. For Australian fixed income, where the total allocation may only be 10%, this might see an allocation of 3% or so per manager. Conversely within infrastructure, particularly large funds who manage their own direct portfolios, the individual asset might be seen as the unit of risk. Thus, within a total allocation to infrastructure of 5-10%, a 1-2% exposure to a single asset might be seen as OK. While the chain of logic to this thinking is intuitively sensible, this approach ignores the fact that the risk of a fixed income manager is orders of magnitude lower than that of a single infrastructure equity asset. For example, for a core bond manager – 2% of underperformance would be a very large adverse outcome – while for infrastructure equity return shocks of 20%+ are quite possible. This approach results in an uneven risk exposure across the portfolio, with much higher idiosyncratic risk in infrastructure and equity portfolios compared to fixed income portfolios.
- ***Skewed returns***. Debt investments have skewed returns – there is the potential for unlimited downside, but capped upside. By contrast, equity investments have more symmetric return potential – there is unlimited upside and downside potential. The argument is then that in situations where there are skewed returns you should pursue higher diversification (simplistically because there are no 'big winners' in the portfolio to offset 'big losers). While this argument has merit – I would question its application to infrastructure equity. In my view, part of the difference between infrastructure and conventional equity investments is that return outcomes are bounded – whether by contract or by regulation. In fact, I would argue that infrastructure equity has a significant element of the capped upside characteristic of debt (which is intuitive and fits the notion that *'infrastructure is a bond substitute'*). This undermines a skewed returns argument for different approaches to diversification between debt and equity.
- ***Benefits of larger positions***. In the case of infrastructure, part of the explanation is possibly that larger equity positions offer attractive benefits – be it in the form of governance rights/control as well as lower management fees. It may be these benefits, which may not exist (or have been identified) for debt investments that drives more concentrated investing in the equity compared with debt. While I am sympathetic to the benefits of direct investing (across cost, transparency and alignment with strategy), I would argue that the benefits of disintermediation exist for both debt and equity investments.

All of this suggests that a rethink of default approaches to diversification is in order, and that there may be situations where accepting lower diversification in exchange for better net of fees risk adjusted returns is warranted?

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