

Is Diversification for Dummies?

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This article appeared in the Northern Advocate on 2 December 2009

This column expands upon Warren Buffett's quote in my previous column: *"Wide diversification is only required when investors do not understand what they are doing."*

Buffett's investment strategies have made him perhaps the most renowned (and wealthiest!) investor of all time. He focuses on a small number of investments – at some stages in his career the majority of his portfolio comprised only 5 investments. Buffett learns everything about the companies he invests in, focusing not on their share prices, but on their underlying businesses.

If you choose to invest your own money, this could be the single most important principle to guide your success. Share markets don't always behave rationally, and share prices are frequently out of sync with the fundamentals of the underlying businesses. During the technology boom of the 1990s, share prices for technology stocks increased rapidly. However, many of the stocks' underlying businesses were poor performers with a low probability of success. Ultimately, investors came to their senses, and share prices crashed as a result.

The same parallel can be drawn with holders of finance company debentures in New Zealand. They were focussed on high coupon payments, and lost sight of the risky loan books of the issuers. However, these investors had limited access to information about the assets of the issuers, which illustrates an important point – minority shareholders receive only the (limited) information a company chooses to disclose. However, majority shareholders, and outright owners, can influence management and strategic direction. Whilst their stake is larger (and often less diversified) their apparent risk is not always lower.

Some of our country's most successful businessmen have built their wealth without diversification. Graeme Hart, Sir Ron Brierley and Sir Robert Jones built fortunes by focussing on a few businesses at a time. The same logic applies to numerous small business owners around New Zealand. Why invest your money in the sharemarket when you can start a business and be responsible for your own success? After all, if it's very successful, you can always list your business on the sharemarket and sell your shares to the punters!