Is your portfolio overly concentrated?

South Africa has a relatively small equities market with a handful of dominant shares, spread across a few sectors, which are available to invest in. This presents a significant risk for investors: a highly concentrated portfolio.

When compared to global markets, the Johannesburg Stock Exchange (JSE) is relatively small, comprising less than 1% of the total global investing universe. It is also highly concentrated, with the top 10 shares on the FTSE/JSE All Share Index (ALSI) making up between 50% and 60% of the index. In contrast, the top 10 shares in one of the world's major indices, the S&P 500, make up just over 20% of the index.

Most of the ALSI's concentration comes from one share: technology giant Naspers, which makes up 20% of the index. Naspers' dominance in recent years has increased concentration risk for investors, making portfolios overly sensitive to the factors that drive its value. In general, most investors are happy to contend with the exposure, as long as they are still generating positive returns. But what happens when the proverbial goose stops laying the golden eggs; when the dominant share(s) in your portfolio begins to perform poorly?

How you can mitigate your concentration risk

As famously stated by American economist Harry Markowitz, who received a Nobel Memorial Prize in Economic Sciences: "Diversification is the only free lunch in finance."

The best way to reduce your concentration risk, without losing out on the potential to earn good returns, is to make sure that you are invested in a combination of assets that have little correlation to one another – essentially, having a diversified portfolio where you generate returns from a wider spread of assets, industries and markets with an acceptable level of risk.

To construct a diversified portfolio, one has to consider correlation and volatility. Correlation measures the strength of the relationship between the returns of two assets. A positive correlation indicates a strong positive relationship, i.e. the two assets tend to have higher and lower returns at the same time – this is indicative of an undiversified portfolio. A negative correlation implies the opposite, i.e. returns of the two assets move in opposite directions at any given time. A correlation of zero implies that no relationship (positive or negative) exists between the returns of the two assets. By adding assets with zero, or negative correlation, a portfolio becomes more diversified.

You should also look at the overall volatility of your investment to gauge how well your portfolio is diversified. Intuitively, a portfolio consisting of correlated assets should show a larger deviation in its overall returns (i.e. high volatility), while a portfolio that has uncorrelated or negatively correlated assets should show smaller deviations in its overall returns (i.e. low volatility). In essence, if you have a well-diversified portfolio, then your investment should generate returns at lower levels of volatility over the long term.

Diversify your portfolio

If all this sounds very complicated, you could consider investing in a balanced fund. These are available both locally and internationally and offer a good solution to those investors who want to create a diversified portfolio without the hassle. Your chosen investment manager will carefully select a basket of uncorrelated assets from different markets, companies and industries to ensure that you generate good returns with minimal concentration risk.

Local balanced funds offer South African investors some offshore diversification, but remember that Regulation 28 of the Pension Funds Act limits their foreign asset allocation to a maximum of 30% of the fund, with an additional 10% for investments in Africa outside of South Africa. This may not be enough offshore exposure for your needs – in which case you can also invest directly with offshore fund managers of your choice or through an offshore platform, such as the one Allan Gray offers. Every South African resident can use up to R11 million offshore for all foreign expenditure including travel, foreign exchange and for investing purposes. The first R1 million, called the single discretionary allowance, can be used without having to obtain permission from the South African Revenue Services (SARS) and the Reserve Bank. If you want to spend above this allowance, up to R10 million, you would need to get a tax clearance certificate from SARS.

To further diversify, many investors choose to invest in more than one of the same type of fund from different managers. If you go this route, it is important to check that the underlying investments are different; otherwise, the combined weighting of the duplicate shares may increase your portfolio's concentration.

Building a diversified portfolio can be complicated and requires a solid understanding of markets and companies. But the good news is that you don't have to go at it alone. An independent financial adviser (IFA) can help you assess the concentration risk in your portfolio and advise accordingly.

It can be tempting to ignore concentration risk when the going is good, and returns are attractive. However, an undiversified portfolio can quickly become a problem if your most concentrated shares begin to perform poorly.

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