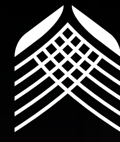


Reserve Bank of New Zealand
Te Pūtea Matua

Upside, downside

A guide to risk for savers and investors

Section 2

I want to learn about investing

Failing to diversify within each type of asset

Some economists claim, “There’s no such thing as a free lunch;” you can’t, for instance, get a high return with low risk. Others disagree; there is one free lunch, they point out. By diversifying across lots of shares, lots of properties, lots of bonds or whatever, you can reduce the total risk of all your investments without reducing your expected return.

To keep the numbers easy, let’s say, for example, the annual returns we might expect on a single share range from minus 40 percent to plus 60 percent, with an average of 10 percent. On a portfolio of 20 shares, we might expect the same 10 percent average return. But the range would be narrower – perhaps minus 20 percent to plus 40 percent – because when some shares do badly, others do well. The return is the same, but the risk is lower.

Market crashes do occasionally happen, when practically all prices drop. But generally, while a single bond or share can become worthless, and a single property can lose much of its value, it’s much less likely that all of them will do badly at once.

Every big institutional investor always diversifies its holdings; you’re silly if you don’t take advantage of it.

You can gain good diversification through managed funds specialising in bonds, property or shares. You also benefit from the savings gained from the manager’s large-scale operations. For example, a fund manager will pay much lower brokerage per share than you would pay if you bought individually. But, as noted earlier, you do have to pay fees, which can partly offset the advantages.

Fixed interest

If you’re investing in investment grade bonds, the bond issuers are not very likely to default. It’s still possible, though, so it’s a good idea to invest in several different companies.

And if you’re investing in higher-risk fixed interest instruments, where default is more likely, it’s particularly important to spread your money around – although even that didn’t save some finance company investors early this century. It’s best to stick with high-quality fixed interest.

Property

With direct investment in property, it’s hard to diversify across many properties unless you have lots of money or are willing to take on the risks of gearing heavily to buy several properties – and can find a lender who will let you do that.

If you insist on direct investment and you can afford only one investment property, keep in mind the following:

- It’s not a great idea to buy a residential rental property near your home. Sure, that means you can keep a close eye on it. But if house values fall across the neighbourhood – and that can happen – you lose on both properties. Lower your risk by purchasing a property some distance from your home, and perhaps in a different type of neighbourhood, such as inner city if you live in a suburban or rural area.
- Along the same lines, it’s rather risky to own more than one property in the same small town, especially if the town is dependent on one or a few industries. If there’s trouble in a local industry, all property values are likely to fall – and you might even lose your job as well.
- It’s also better if you buy a different type of structure, such as a unit or apartment. The house and apartment markets are somewhat different.
- You can get better diversification still if you invest in a commercial property, such as a shop, office building or factory. Their markets differ even more from the housing market – although all property markets are affected to some extent by common factors such as interest rates.

Best of all, is investment in a broad range of property types in different regions. For many, the only way to do this is via a property fund or shares in a company that invests in many properties.

Shares

> *"Well-informed investors diversify because they do not believe that investing is a form of entertainment."*
>
> – Economist Peter Bernstein

Many New Zealand shareholders own shares in just one or a few companies. That's not clever. Holding just two shares gives you considerably more diversification than one. Three is better, and 10 is better still. Some experts say that, to get the full benefits from diversification, you need to hold 20, or even 50, different shares.

The easy way to do this is via a share fund or several funds. If you prefer direct share investment, make sure you spread your holdings across different industries and company sizes.

Concentrating on just one industry, as some investors did during the tech stock boom of the late 1990s, is highly risky. Many tech stock investors saw the value of their portfolio reduced to a fraction of what it had been before the inevitable bust came.

And technology is not the only volatile industry. In worldwide sharemarkets in 1999, the top four performing industries out of 10 broad categories were IT, telecommunications, consumer cyclicals and basic materials. Six months later, they were the bottom four.

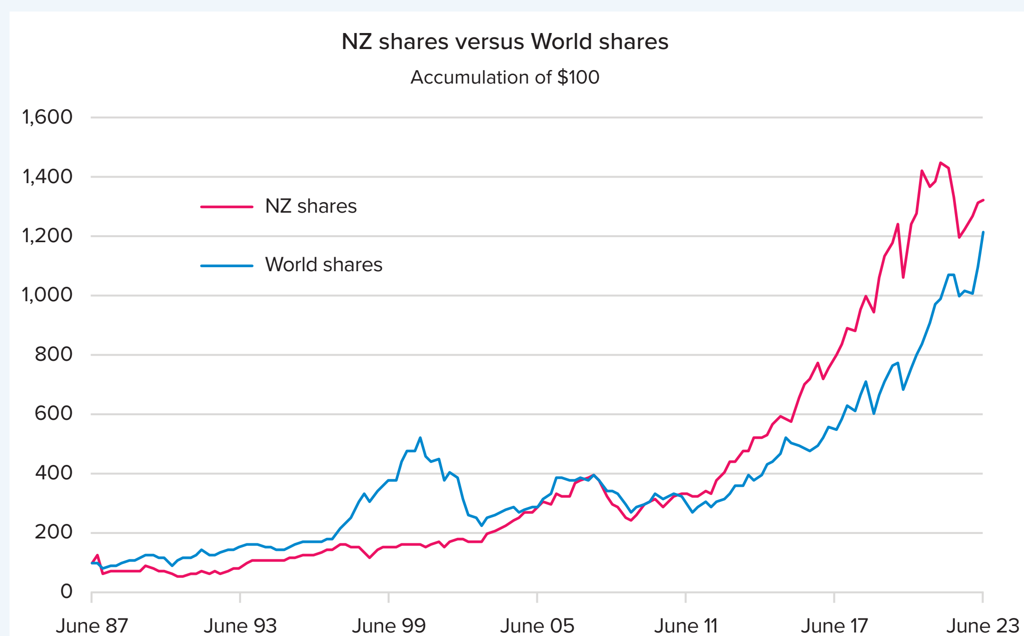
People who invest in a wide range of industries tend to have a much less bumpy ride.

Going offshore

With all types of assets, you can boost your diversification considerably by holding international investments as well as New Zealand ones. It's not uncommon for international investments to be rising while local ones are falling, or vice versa.

Graph 2

International and New Zealand share prices don't always move together



While the long-term trend in both New Zealand and world share markets is upwards – and over the period 1987 to 2023, the two markets have ended up in roughly the same place – at times the two markets perform very differently.

The easy way to invest offshore is via managed funds and it's common for even small investors to hold units in an international share fund. As it happens, international shares have had a really up and down ride in recent years, growing extremely fast in the late 1990s, dropping an unusually long way in 2000 to early 2003 and growing again since then, only to plunge in the global financial crisis and recover since – with a few wobbles along the way

Over the long term, though, average returns on international shares have been high. And you can invest in many industries that are under-represented in the New Zealand share market.

Because the New Zealand and world share markets sometimes move quite differently, as our graph shows, you can broaden your share diversification considerably by including an international share fund in your portfolio.

Similarly, you can invest in international bond or property funds.

KiwiSaver

Almost all KiwiSaver funds hold a wide range of investments in the asset types in which they invest. For example, a predominantly bond fund holds many different bonds, and a predominantly share fund holds many different shares. And many KiwiSaver funds have considerable international investments. Your provider should be able to give you information on their range of investments.

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