Concentration…. a hidden risk

Managing Your Money

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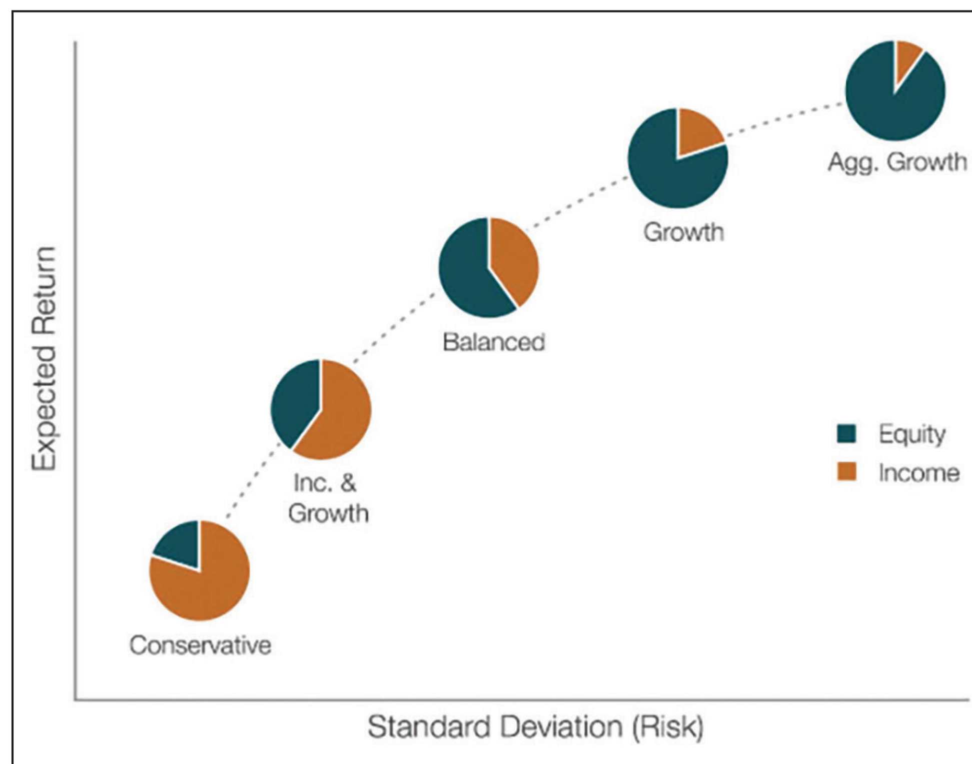
I recently had a very nice lady contact me for a second opinion on her portfolio. She is recently retired and trying to make sure that her investments are in good order. Mary, as we'll call her, described herself as being conservative, and didn't want to take too much risk. However, she also felt like she was missing out on the recent gains that we've seen in the market. (Easy to say in hindsight after the markets have outperformed!) After a thorough assessment of her risk tolerance, it was clear that she wasn't comfortable with volatility, and wanted a "safe" portfolio. She had been working with the same advisor for years at a reputable firm. Considering all this information, I was surprised when I evaluated her portfolio and saw a high concentration in one type of investment, thereby increasing her portfolio risk. She was not aware of 'concentration risk', as she thought that type of investment was "safe".

Asset Concentration Risk

Concentration Risk is when investors rely too much on a single investment or type of investment. This can happen by having too much invested in a single stock, bond, industry, geographic region, or any other area or focus. Some of the potential risks of being overly concentrated include: portfolio underperformance (like the investor in the case above), portfolio volatility, and potential loss if forced to exit at the wrong time. Often investors end up with concentration risk because they've been holding an investment for many years and don't want to sell and trigger a capital gain. It's critical to consider taxes in any investment decision but basing an investment decision on taxes can be risky! Think of the Nortel fiasco, where many people did not want to sell because of taxes. In the end, I guess they ended up paying no taxes once Nortel lost all its value. And there are many other examples of this. In my practice we have methods to diversify out of a single position without triggering capital gains taxes, so taxes should not be the reason for building concentration risk.

Modern Portfolio Theory

It is commonly known that diversification within an investment portfolio reduces risk. Portfolio construction has been based on this concept since 1952, when Harry Markowitz introduced Modern Portfolio Theory, and was later awarded a Nobel Prize in Economic Sciences for his work. Modern Portfolio Theory uses the core idea that owning a portfolio of different asset classes is less risky than holding a portfolio of similar assets. It suggests that an investor must be compensated with a higher expected return for taking on a higher level of risk. While I'm oversimplifying Markowitz's theory above, the bottom line is that diversification is key – that better returns, and less risk can be achieved with a proper combination of investments or an "efficiently diversified portfolio". The graph below shows a simplified version of this theory.



Source: Morningstar

Asset allocation

Asset allocation, or how you diversify your portfolio among different asset categories, will be the biggest determinant of your investment risk and returns. Research shows that only a small fraction of total lifetime return comes from individual investment selection. The largest drivers of investment success are decisions on the asset mix and how people react to market dynamics. By spreading your investments properly among different assets classes, geographic regions, management styles, and sectors, you minimize the risk of being overexposed in the wrong investment. Based on your unique situation and the objectives of the portfolio, a strategic asset allocation should be established, continually monitored and adjusted as required for suitability and performance considerations.

In Mary's case above, both the advisor and the firm missed the high concentration risk. Take the time if you have the knowledge to assess your investment allocation or get a second opinion by another professional. There is no one size fits all when it comes to investments, and therefore opinions may differ on what is the ideal allocation. But exploring different opinions may also help identify a potential problem, or opportunity, that is currently being missed. Knowing where you are today will lead you where you want to be tomorrow.

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