Diversification is risk; Warren Buffet & The "paradox" of diversification

There has been comment recently with respect to what has apparently been Warren Buffet's first investment overseas. The inference of these statements is that **because the world's most famous investor does not diversify internationally to any great extent,** that ergo international diversification is not necessary.

However, for the average investor to use such a yardstick without fully understanding the "yardstick" could be folly indeed.

It must be noted that Warren Buffet does not follow conventional modern portfolio theory structure and therefore his risk and return management paradigm will differ. For one his preferred level of stock holdings is between 10 and 12 stocks. Most diversified portfolios hold upwards of 20 stocks and most mutual fund portfolios hold much more.

In fact, buy an index investment, or have an allocation that more or less mirrors the composition of the index (give or take 10% to 20% of the market weighting) and you hold the market, more or less.

Now, one could deduce that he holds 10 to 12 stocks not because he believes that this is all you need to manage stock market risk, but because this is the optimum number of stocks for his investment style.

One could deduce that Warren Buffet really views diversification as a return management platform, not a risk management platform. His risk management is determined by his stock selection discipline and his stock selection discipline is based on a combination of stock valuation and assessment of fundamental business structure and rationale.

Whereas a diversified portfolio minimises the risk of being exposed to any one company (and hence is a risk management platform), Warren Buffet looks to increase his exposure to the specific risks of individual companies (and hence his is a return management platform). It is Warren Buffet's approach to stock selection that limits the number of holdings he can manage at any one point in time and which effectively limits his ability to, or precludes the need to, diversify globally.

> Perversely and paradoxically, a Warren Buffet portfolio has more of the risk that today's "modern portfolio theory" looks to average away. This risk is the specific risk of the business. Modern portfolio theory states that you can minimise your exposure to this risk by holding more and more stocks, until all you are left with is market risk. As such, you could term Warren Buffet's approach as one that is efficiently exposed to specific risk, while modern portfolio theory is one that is efficiently exposed to market risk. Warren Buffet gets rewarded more for taking the specific risk of the company than for taking the risk of the market.

Importantly, by taking on the specific risk of a small number of holdings, if done properly, you end up minimising your exposure to broad market and economic risk. TAMRIS terms this efficient management of market risk.

By diversifying across more stocks you reduce the specific risks of holding individual stocks and become more exposed to the market and economic. TAMRIS terms this efficient management of specific risk.

It is the exposure to market and economic risk characteristics of a more diversified approach (or a passive index approach at the extreme) that needs to be managed by global diversification. Without global diversification, your portfolio and the portfolio's ability to meet financial needs over time is exposed at all points in time to specific market and economic risk.

To say that most investors do not need international diversification because Warren Buffet does not, ignores not just the structural integrity of his approach but the structural paradigm of most individual portfolios.

If you do not follow Warren Buffet's approach and hold a diversified portfolio of domestic stocks and only domestic stocks you are fully exposed to domestic economic and stock market risk.

In this case there is no rationale whatsoever for not holding a healthy dose of international market allocation. You would be a fool not to and this is one of the apparent paradigms of diversification.

The only way to manage the market and economic risk within diversified portfolios is to diversify internationally. ***This is Warren Buffet's implied lesson or rule***.

In truth, Warren Buffet is the exception that proves the rule, as in truth all individuals are.

If you are going to learn anything from him, learn the rules to his exception and the risks of applying the exception to the paradigm of the norm, or your own particular paradigm.

And the paradigm of the norm is this; most individual investors and investment professionals invest in equities per se to gain the market return and not the specific return of individual stocks and most individuals are not able to stomach the costs or the risks of a Warren Buffet approach. The costs or the risks equate to the certainty of under performing, at times often significantly, the market over the short term.

> Even the astute manager knows that most individuals could not accept the risks of Warren Buffet's approach. Holding just 10 to 12 stocks of companies that most investors would not consider fashionable and 10 to 12 stocks that will be guaranteed to under perform the market for substantial time periods cannot be stomached by the majority of investors. Indeed the majority of asset managers cannot stomach this risk. For those who attempt to take this risk you will find that legions of investors will dump their funds.

Now, there is no reason why any one investment discipline needs to follow that of Warren Buffet as long as the individual is fully conversant with their own paradigm, their own theoretical structure which determines how they manage risk and return.

Moreover, the fact that Warren Buffet does not invest overseas does not mean that Warren Buffet disagrees with overseas investment. The reality is this, if he is going to limit himself to 10 or 12 stocks and know the stocks well and there is a sufficient pool of stocks to meet his needs in the US market he will limit himself to these stocks. Going abroad means taking additional risks, risks which may run counter to his own investment style. Indeed, the only way he could accept more risk is to diversify, which means holding more stocks than he can manage the risk of, which again contravenes his own paradigm.

So just what are the apparent paradoxes.

- Diversified domestic portfolios used to manage risk actually increase risk by fully exposing you to domestic economic and market risk.
    - Only a portfolio efficiently exposed to specific risk (Buffet style) can minimise exposure to market risk and only a portfolio efficiently exposed to market risk (market index) can efficiently minimise exposure to specific risk. Note that exposure to specific risk that minimises market risk does not have to be accessed by direct equities, it can be accessed by allocation to broader stock characteristics; market cap, sector and growth/value styles.
- Within a global market, a well diversified domestic market exposure poses a higher level of specific market and economic risk and this risk varies according to the relative size of the market and the composition of the market relative to the composition of the global market.
    - In fact, the larger the global market relative to the domestic market and the larger the differences between the global market composition and the domestic market, the greater the need for international diversification. This is because the specific risk of a given market is skewed to the allocation profile of that market.

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- Diversified international allocation needed to reduce the domestic economic and market risk actually increases the risks of underperforming the market; in other words creates the type of risk more often associated with portfolios efficiently exposed to stock specific risk.
    - This also means that global allocation also provides return as well as a risk management platform for those able to manage this allocation.
- The further you move away from Buffet the closer to him you become. That is in order to get away from Buffet type specific risk you not only need a diversified market portfolio, but also a global market exposure which effectively exposes you to some of the performance risk characteristics of specific risk.

The Canadian Perspective

Canada is a very small part of a very large global market. Moreover its own market composition differs significantly from the global market composition. Investors with broad Canadian exposure and limited overseas allocation are highly exposed to the risks of the domestic market and economy.

For example the Canadian market's allocation to energy stocks is some 260% of the global market's allocation, as is its allocation to material stocks.

At a time when both commodity stocks and the Canadian dollar have risen strongly, the market and economic risks of diversified investment in the Canadian market could well be considered high.

Canadian stocks represent only 3% of the world's total market capitalisation. Just how much allocation to the Canadian and global markets is sufficient to manage risk and return for a given investment style and given individual's personal financial needs? Your wealth manager should have a handle on this.

Just what is your advisor's paradigm and how does this affect the need for international diversification?

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