Seven
Investment Management

The importance of being diversified

Idiosyncratic. Unsystematic. At 7IM we pride ourselves on many things, such as being different and in our ability not to confuse our customers. We also like to think that we know more big words than the average Big Brother contestant and these two words, idiosyncratic and unsystematic, I think sum up all those traits very nicely.

In reality though, these are words we hate and do everything we can to avoid when we have our portfolio manager's hat on and I think the ongoing crisis at BP demonstrates why.

BP was the largest company in the UK equity market. At the end of 2009, before the Gulf of Mexico oil spill, BP was so big that it made up over 9% of the FTSE 100 index and about 15% of the FTSE 100 dividends. BP has fallen about 38% since the beginning of the year, most of that coming as bad news has piled on bad news as the Gulf of Mexico disaster worsens and the political pressure builds.

The FTSE 100 index has dropped by 202 points since the start of the year (as of midday on 14th June 2010) with BP's sheer size accounting for 170 of those points. By way of contrast the woes of the Prudential's failed take-over bid, one of the other underperformers of the FTSE 100 index, has only taken 8 points off the FTSE 100 index.

For some unfortunate investors, who were not as fully diversified as they thought, the Gulf of Mexico oil spill has been a very painful event. Even more so if BP cuts its dividend as President Obama has demanded it do. This will be a severe blow to those investors who bought BP for its seemingly safe 6% dividend yield.

The risks investors take

The risk of taking a financial bath from a stock is known in the academic text books as "idiosyncratic risk" or "unsystematic risk". This is the risk that as an investor you will be affected by a company specific event. We see company specific events hit stocks time and time again all the time. There are many such instances. In recent memory the disastrous acquisition sprees that led to the demise of RBS and GEC, the accounting frauds at Polly Peck, Enron in the US and Parmalat in Italy, plain bad management at Northern Rock and finally the foot in mouth comments of Gerald Ratner, the jeweller, who literally described his company's products as crap!

These are all examples of how an undiversified investor can take a real bashing in his pocket. However all is not lost because, apart from being difficult to pronounce if you have false teeth, the beauty of idiosyncratic or unsystematic risk is that you can more or less get rid of it by diversifying in a steady cautious and informed way.

How to diversify?

Some investors mistakenly assume they are diversified by buying a little bit of Shell, a little bit of BP and a little bit of Tullow Oil. Intuitively, you should be able to see that this is not a diversified portfolio at all. Yes, you may diversify away a little of the impact of the Gulf of Mexico disaster, but you have not diversified away fully your risks in a drop in the oil price, a change in UK interest rates, a change in the UK tax rate or the many other common risks these three companies share.

Creating a fully diversified portfolio is very difficult and also expensive. You might suggest adding some Marks and Spencer to diversify your risk arising from oil price movements, but that still leaves you open to other risks such as changes in UK interest and tax rates. Pretty quickly you might see that diversifying is a bit more complex than you might originally think. The UK specific risks for example, like tax rates, can indeed be largely diversified away, but only by investing in overseas companies and this is often beyond the expertise of the best of us.

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How diversified are the 7IM portfolios?

The 7IM portfolios have been put together to all but eliminate the "unsystematic" risk or "idiosyncratic" risk, or the risk of a company specific event hurting your portfolio. The funds are fully diversified by specialist portfolio managers from across all the world's major equity and bond markets.

The diversification process goes on at two levels. First of all, we use a firm of consulting PhDs, Ibbotson Associates, to do all the heavy maths for us to calculate the most cost effective way to diversify across all the different global equity and bond markets – a form of diversification that allows us to try to maximise your returns for a given level of risk.

Secondly, we either employ the top fund managers for each major region to do our investing for us, or we use broadly diversified instruments such as ETFs or index tracking funds to invest so that we are never over-invested or over exposed to any one stock.

This is not to say that we eliminate risk altogether. "Idiosyncratic" or "unsystematic" risk may be to all intents and purposes eliminated, but the broad risk of the market still remains. This broad risk is called, funnily enough, "market" risk or "systematic" risk and is the risk in the market that cannot be diversified away. You can buy all the equities or bonds in every different market, but you will still have the risk that markets can go up and down in an unpredictable way.

The extent that your portfolio goes up and down or how much market risk is in your portfolio is largely a function of the level of cash, bonds and equities you choose to hold. This in turn is unique to your personal circumstances and may often require you to seek the help of a Financial Adviser to help plan your long term needs. However, at least with a 7IM fund forming the core of your portfolio you can be sure that you will never need to Google two big words – idiosyncratic and unsystematic.

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If you would like more information about the 7IM approach to managing money or for details on our funds and services, please contact us on 020 7760 8777 or email information@7im.co.uk

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