Is This Risk Set to Destroy Your Portfolio Returns?

Description

With stock markets across the globe having enjoyed a major Bull Run in recent years, many investors are feeling optimistic about the outlook for their portfolios. This is understandable, since the S&P 500 and many other major indices are close to their highest-ever levels. This means that confidence is generally high and return expectations are also upbeat.

However, there is a risk that this optimism leads to complacency. Investors may begin to take risks which are either too great, or are not commensurate with the potential rewards on offer. One risk could be concentration risk, and it could become a major problem for some investors.

Changing perspective

History shows that during bull markets, investor psychology changes. Investors become more confident not only in the prospects for the world economy, but also in their ability to pick winning shares. The reason for this is fairly obvious: they have enjoyed a high level of success as stock markets have risen, and attribute much of this gain to their own methods and ability.

The result of this increased confidence in their own ability can be higher concentration risk. Investors may decide that they no longer require the high degree of diversification they have adopted with success in previous years. Since their investments have generally risen, they may start to back their judgement to a greater extent. This can mean they hold fewer stocks in greater quantities, which leaves them open to company and sector-specific risks.

Possible difficulties

Although a bull market can continue over a sustained period of time, company-specific and sector-specific risks remain. Any company can experience a difficult period of trading at any point in the economic cycle. For example, its end markets may underperform, and this can cause its earnings growth rate to be lower than anticipated. Similarly, a change in regulation could hurt an entire sector and lead to share price declines across an industry.

An investor who has few stocks in greater quantities could be hurt to a much greater extent by such problems than a well-diversified investor. Therefore, it seems logical for all investors to retain a high degree of diversification at the present time – even if they have been able to generate high returns in recent years.

Bear market

The same principal could be applied to asset allocation. While shares appear to offer the best risk/reward ratio of major asset categories at the moment, it is prudent to maintain at least some cash within a portfolio in case of a stock market correction, for example, Furthermore, holding bonds and investments in property is also logical, since they may provide greater stability as well as help to reduce risk over the medium term.

While it is easy to become more confident about the future potential of a portfolio while share prices are at record highs, guarding against concentration risk could be a sound move for all investors to make.

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