Brainy's Articles on

Share Trading**

Investing for enjoyment, asset class and diversification

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Introduction

A lot is said by the industry professionals and experts about the pros and cons of investing in different *asset classes*, and the notion of *diversification*. However, they tend not to provide the complete story.

Have you ever wondered why some people spend time researching information on one specific asset class at the expense of other opportunities? And some people spend inordinate amounts of time on some specific investment activities, while other people seem to be not the least bit interested. Ever wonderer why?

Table of Contents

Introduction..1
Investing for enjoyment?....................1
Different asset classes.......................1
Diversification....................................2
Diversification across market sectors 3
Diversification — the sceptic's view…3
Summary..3

This Article in Brainy's series on Share Trading and Investing (number ST-4010) firstly offers some thoughts about the underlying reasons why some people invest in some *asset classes* and not others. The article then discusses the notion of *diversification* across asset classes, and offers some thought provoking ideas.

Investing for enjoyment?

Before discussing asset allocation, and the range of asset classes and sub-classes that we could invest in, it is worth considering the investing enjoyment factor. Have you ever wondered why some people invest in the share market, while others trade foreign currencies, and others trade in commodities?

Have you considered that perhaps they *invest for enjoyment*?

When we stop and look at it, some investors are fanatical about investing in artworks, and some in coins, and some in stamps. But why do they do it? Well, it's simply because they enjoy the research and the participation. When you think about it, it's rather obvious. They simply wouldn't do it if they didn't enjoy it.

Some investors spend a lot of time studying and researching real estate investment opportunities. They might focus on residential housing opportunities, and study the geographic trends to find localities that are likely to see surging prices in the near to medium term. But why do they do it, and others don't do it? It is again to do with the personal enjoyment of the research and participation.

And what about the investors who like to invest mostly in small-cap mining and exploration stocks that seem to have significant potential? Again, for the enjoyment of the research, and the participation.

Why do some investors really love to pore over the financial statements of large-cap companies in an attempt to calculate today's fair value, and to estimate the earnings growth and likely future share price value? Again, because they really enjoy doing the research, and using a computerised spreadsheet tool to crunch the numbers in order to arrive at a numeric value on which they can hang their hat.

It is easy to see that the driving force that pushes people to invest in different opportunities is not much different to the driving force that pushes people to spend time on specific leisure pursuits or hobbies. Likewise for their chosen sporting activity — be it football, cricket, tennis, squash, sailing, cycling or some form of martial arts.

Different asset classes

Many investors will think about the possibility of spreading investment capital across several asset classes. We are often encouraged to diversify our investments in order to spread the risk. The experts are always reminding us that this is good investment practise. But what are these *asset classes*?

** - The two words *trading* and *investing* are often used somewhat interchangeably.

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The three traditional asset classes are:

- equities (stocks, shares);
- fixed-income (bonds); and
- cash equivalents (money market instruments, bank deposits, term deposits).

We can also consider the additional asset class *categories* such as:

- real estate (commercial, residential);
- managed funds;
- Exchange Traded Funds (ETF);
- commodities (precious metals, non-ferrous metals, agriculture, energy);
- collectibles (art, coins, stamps);
- insurance products (annuity, life settlements, personal life insurance products, etc.);
- derivatives (long-short or market neutral strategies, options, collateralised debt, futures);
- foreign currency.

Other relevant considerations that could be factored in include: growth stocks, value stocks, market capitalisation (small, medium, large) and the different types of fixed income (debentures, government bonds, corporate bonds, municipal bonds).

In discussion, the distinction between asset classes, and sub-classes (or categories) is often blurred. For simplicity, in this article and in many other writings on this topic, the term *asset class* is often used to loosely refer to asset *sub-classes* and *categories*.

So, how do we decide where to park our investment capital? The range of options regarding asset class is rather extensive. So, how do we choose one or two? Or several in order to spread the risk? Well, one useful and practical angle is to focus more on the asset classes which we can easily relate to, and in which we would enjoy participating. Is there a need to invest across several asset classes? Is it useful to diversify? [Note: these comments are offered as thought-starters, and not as investment advice.]

Diversification

Let's now consider the notion of *diversification*. What are the reasons for diversifying our investments? Well, there is really only one main reason — to spread the risk. By investing across different asset classes, if one class suffers some sort of catastrophe which impacts on our investment in that asset class, then the flow-on effect on the other investments in other asset classes may not be great.

In this context, *spreading the risk* is basically the same as *reducing the risk*.

However, there is something about diversification that the experts don't tell us. To support their comments and recommendations they often refer to academic studies which prove that diversification works, and that it is cost-effective over time. What they don't tell us is that there are underlying assumptions to the studies — assumptions such as long-term investment horizons utilising the old and weary buy-and-hold investment strategy. So what if we are not interested in holding long-term? What if we are more interested in gaining better returns in the short to medium term? In this case the studies actually become irrelevant, and in fact misleading.

Here's another angle. Much of the material that is written about investing, and diversification, assumes that the reader is a long term buy and hold investor. And it tries to somewhat simplify the topic by reducing the complexity of the topic. It supports investment methods that the investor is supposed to simply "set and forget". However, many investors have been learning that the simple buy

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and hold strategy doesn't work any more. And many investors are now rather active with their investing activities.

What the experts don't tell us is that if we want to be an active investor, and if we are prepared to monitor our investments and close out under-performers quickly, then diversifying our investments is likely to reduce the risk of catastrophe, but it will also reduce our potential returns. That is, if we want to maximise our returns with active investing then we should not worry about diversification for the sake of diversification.

Diversification across market sectors

Another consideration regarding diversification is that if investing in shares, you might want to spread the risk by investing across different market sectors. And I you felt that one sector is higher risk than another, then you might choose to avoid the high-risk sector. It should be mentioned here that the more risk-tolerant and more active investors might choose to ignore an allocation based on market sectors. Even the experts have trouble trying to get this right.

Diversification — the sceptic's view

If you ask the proverbial sceptic for an opinion about diversification, they might suggest that the finance industry professionals (such as financial planners, and the sellers of financial products) like to recommend it so that investors have lower risks, and a lower chance of something to complain about should things go wrong. But also because the eventual investments might result in a higher income stream for the seller of the investment product.

By encouraging diversification, and exposure to other asset classes, an investor might feel out of their depth, and prefer to leave it to the professionals — which is just what the product sellers want.

Don't forget that many (not all) of the sellers of investment products are primarily interested in their own take-home income. During bear market periods when investors might lose something like 30 to 50 percent of their investment, many of the investment product sellers still take home their commissions on (failed) investment products. And their own income is increased with more “funds under management”.

Summary

In this article in Brainy's series on Share Trading and Investing (number ST-4010) we have offered up a sound reason why some investors spend their time investing in collectibles like artwork or coins, while others spend their time on researching property. We have also briefly looked at the topic of *asset classes*, and the notion of *diversification*.

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