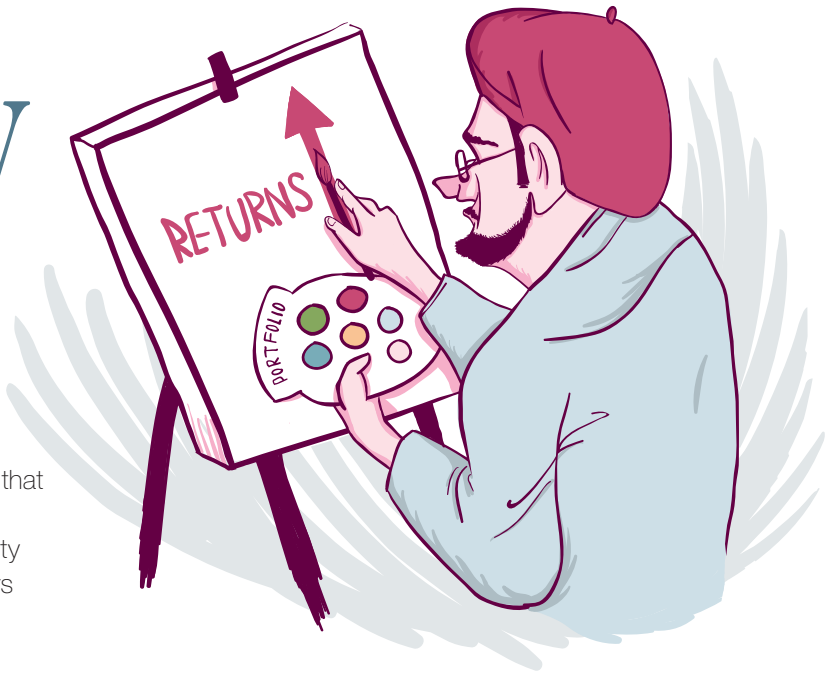


# Simplicity Is Beauty

By Eng Tiang Chuan



Like a stunned rabbit staring into the lights of an oncoming truck, investors have been left bewildered in the wake of the 'perfect storm' that swept the world of investments. However, an investment portfolio constructed with simplicity in mind can go a long way in helping investors manage and maintain their portfolios.

In the aftermath of the collapse of complex structured products built on Collateralized Debt Obligations (CDO), investors have shifted their attention to traditional asset classes like cash, bonds and real estate. The latest Capgemini/Merrill Lynch World Wealth Report found that global High Net-Worth Individuals (HNWI) allocated more to the above mentioned asset classes in 2008. Allocation to equities and alternative investments dropped.

The Monetary Authority of Singapore (MAS) has also banned the use of terms like 'Capital Protected' or 'Principal Protected' to simplify the selection process for investors. 'Capital Protected' products may not guarantee the capital and investors may thus be confused by such terms. The sales of structured products in the retail market have also been drastically reduced.

Over the past year, much of the media discussions and official developments have been on the need to have simpler and easy-to-understand products. Little has been mentioned about the need to have simple portfolio constructions.

## PORTFOLIO CONSTRUCTION AND ASSET ALLOCATION

Proper portfolio construction entails diversification over geographical and asset classes. This is a bid to own various assets of low correlations in order to lower portfolio risks. But as we have seen in the financial crisis, many assets have a much higher correlation than was expected. The theory of Asia 'de-coupling' from the developed markets was crushed. Asset classes from properties to commodities dropped in tandem.

Many investors panicked over the losses in their portfolios and do not know what to do. Without a proper and simple portfolio, they could not identify rebalancing opportunities and instead of re-allocating to the discounted asset classes, they shifted to safer instruments. In doing so, many investors missed the great opportunity to invest into equities at rock bottom prices. Investors would have recovered a significant part of their losses if they had stayed invested.

A high number of investors do not do proper investment planning and asset allocation. A typical investor would invest based on product recommendation instead of how it fits into a portfolio. Such recommendation could come from friends, Relationship Managers, stock brokers or financial advisers. Conventional consideration would be based on historical performance and not asset allocation considerations. As time goes by, investors may find that their many overlapping holdings are exposed to the same underlying industries. As in fashion, the investment world is filled with different fads at different times. Remember the Internet/Technology fad? What about the lure of BRIC (Brazil, Russia, India, China) nations? How about Climate Change? This problem is worsened by the tendencies of investors to hold on to loss-making instruments. Without an allocation plan in place, many investors become 'collectors' over time as the number of different holdings increase.

## MULTIPLICATION IS NOT DIVERSIFICATION

Multiplication does not mean diversification. Holding many similar holdings does little in controlling the portfolio risks. Investors might

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be investing into the same underlying instruments without knowing it. For example, investors who hold First State Bridge and First State Dividend Advantage would find the funds feeding into the same underlying Dublin domiciled First State Asian Equity Plus Fund.

With Emerging Markets (EM) and BRIC touted as the new growth areas, many investors have made a beeline for Emerging Markets and BRIC funds. A random check revealed that many EM funds holds nearly 50 per cent of their holdings in BRIC. Having high allocation in both funds could result in too high an allocation to these countries. Also, by virtue of the make up of the countries' economy, different countries may have high allocation to different sectors. Investors who hold single country funds like Brazil, Russia and Australia would have higher allocation to the Commodities and Energy sector. Coupled with allocations to EM, BRIC and Commodities sectors, investors could end up with a higher than desired allocation to the Energy and Commodities sectors.

## KEEPING IT NEAT AND SIMPLE

Constructing a simple portfolio does not mean that only traditionally long funds are used. Investors with access to Alternative Investments can still have them in their portfolio. However, the investor should be clear and mindful about the allocation to Alternative Investment and not mix them up with other traditional investments. The objective is to have a clear and apparent portfolio construction that is easy to understand.

Keeping your investment portfolio simple brings many advantages.

- Easy for investor to understand the portfolio. The investor can know easily how the portfolio is allocated. With this knowledge in mind, the tendencies for the investor to panic-sell are reduced. The recent financial crisis is a great example. Without a simple portfolio in place, investors might not even know what hit them. The understanding of the source of risk would be much better with

a simple portfolio. For example, investors who have used emerging market or high yield bonds as the low risk allocation would be left disappointed during the financial crisis as they dropped in tandem with the stock market. The risks of unknown unknowns would be lower with a simple portfolio.

- Facilitate portfolio management and maintenance for adviser. An adviser is only human. A complicated portfolio would only make things difficult and create more opportunities for mistakes. Paperwork and administration is also simplified. Changes in fund specifics like fund mandate and dividend declaration could be followed more easily.
- Ease of Rebalancing. Rebalancing is an important part of portfolio management and maintenance. A complicated portfolio with many funds overlapping geographical and sectoral holdings would make rebalancing a hassle. Selection and the transaction administration work would become an effort. The investor or adviser might be put off carrying out the necessary rebalancing work and end up with an unsuitable portfolio.

## CONCLUSION

Just like how machines with simple designs can help the user complete a job with certainty, a simple portfolio can help the investor achieve his financial goals with ease and confidence. A simple design often means a robust and lasting makeup. Repair and maintenance is easy and problems can be spotted effortlessly. For investment, just like it is for machine design, less is often more. ■

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