Diversify to Survive Market Turmoil.

Many investors have come to expect bouts of volatility once or twice a year, where the very powerful emotion, greed, is overcome by the even more powerful fear.

The fears tend to relate to the same issues; slowing growth/recession, over valuation, inflation, externalities (avian flu, Iraq, 9/11) and so forth, but generally investors have learnt that equity markets tend to recover, so buying on the dips, or sitting on your hands, has proved to be very rewarding.

Every crisis that now appears still tends to be greeted with surprise, but investors have become increasingly willing to believe that the recovery is just around the corner. There is a danger that such behaviour is becoming engrained, much like in March 2000 where there was a belief that investors would continue to buy on the dips despite the fundamental overvaluation of technology related shares. This proved to be true for a while, despite the warnings coming thick and fast from increased volatility, until eventually the evidence became too stark for investors to ignore and the Bear market began.

March 2000 may also be used to illustrate another feature of investors' behaviour; momentum investing leading to increased portfolio concentration. There is substantial evidence that investors tend to like to buy assets that are appreciating, which can give rise to the herd mentality, as more and more people begin to recognise that a certain theme, or asset, needs to be in their portfolio. In turn this leads investors to raise assets from areas that they are disappointed by, in effect selling current losers to buy current winners. As the theme or asset continues to appreciate it is very likely that investors become more convinced of the Bull case and concentrate their assets into a narrower and narrower selection of correlated securities, for instance Technology, Media and Telecoms shares.

The net impact of this is that when the momentum disappears, fundamentals reassert themselves and the "Diversified Portfolio" of securities is proved to be nothing of the sort and spirals ever downwards, destroying wealth in a very short period of time.

The reason I have chosen to remind readers of these events is that I feel there is a danger that we are about to see a repetition of these factors. The rebound in markets occurred in March 2003, nearly 5 years ago, during which time we have experienced various bouts of greed turning to fear and back again.

As the rewards over the last 5 years have overall been good these assets naturally become larger parts of a portfolio, just by growth, let alone the normal behaviour of adding to winners. Medium or short-term losers continue to be beaten up as the last investors capitulate to buy the excitement of recent winning asset classes.

To be able to overcome these issues I think it is apparent that investors need to remind themselves of some of the rules of investment: Disciplined diversification provides protection. Investors must set a medium term forward-looking strategy (current momentum may disappear) and not focus on short-term considerations and where possible, invest using specialist advice.

March 2008