NEW ROAD CAPITAL
INVESTMENT MANAGEMENT

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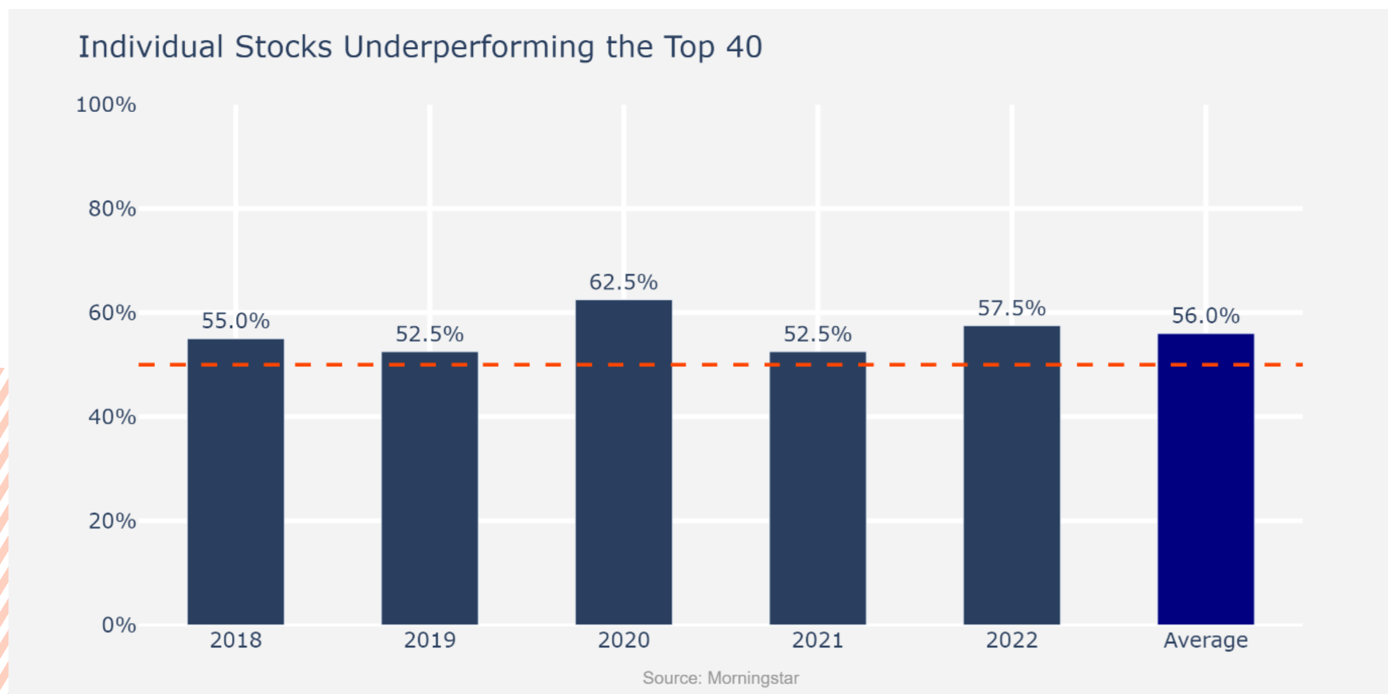
Greater Than the Sum of its Parts

by Garrett Nel

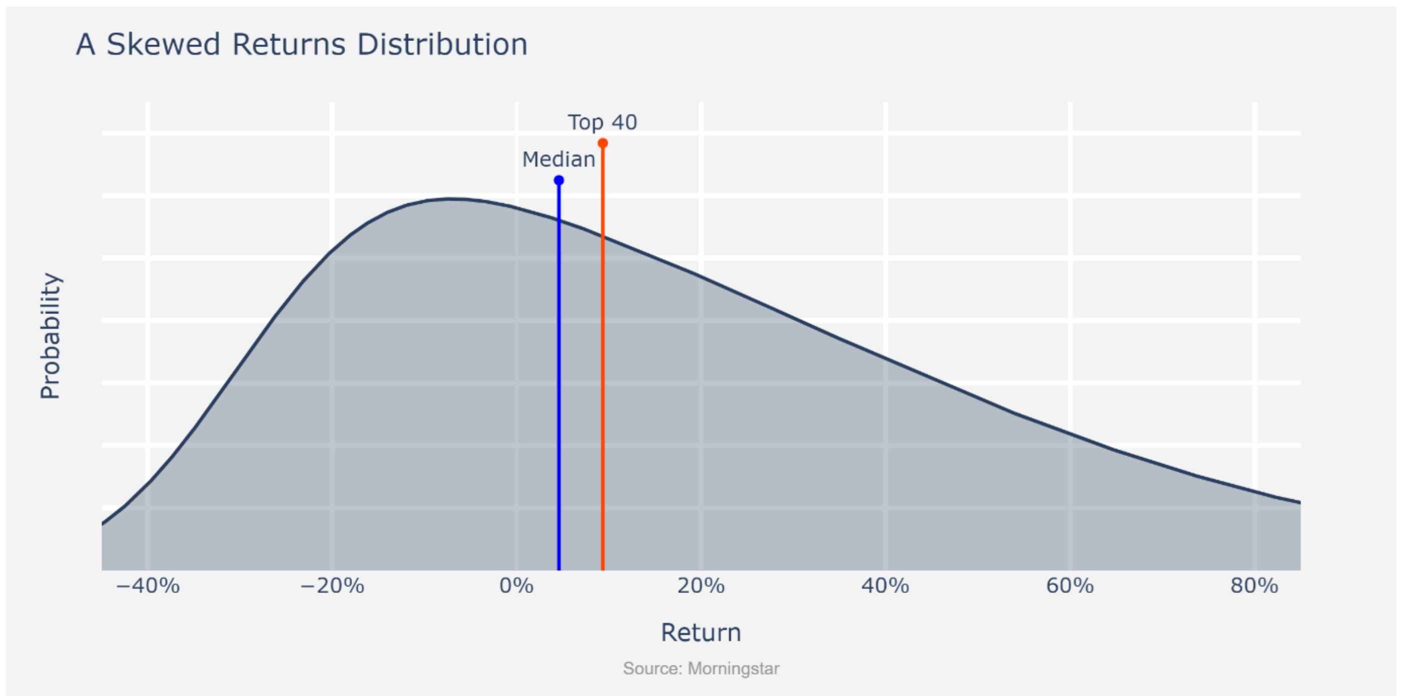
The concept of minimising investment risk through diversification is a commonly understood topic and is widely regarded as the only true “free lunch”. The minimisation of risk is done by eliminating to a large degree the effects of idiosyncratic—or company specific—risks, which leaves the investor exposed only to the market as a whole, where they can enjoy returns explained by the risk taken through exposure to the asset class, not individual securities. However, there is a more counterintuitive benefit to investing in the market as a whole versus selecting individual stocks: most securities that make up the market perform worse than the market itself.

To illustrate an example of this phenomenon, consider the returns illustrated below of the FTSE/JSE Top 40 Index over the last 5 years, compared to the performance of its constituents, the largest 40 listed equities in South Africa. Somewhat surprisingly, over the last 5 years, on average more than 56% of shares that make up the index underperformed the index itself.



This result has practical implications for the active investor: It means that each stock chosen in an actively managed portfolio only had a 44% chance of outperforming the market.

There is a simple mathematical explanation as to why individual securities tend to perform worse than the market on average: the returns of these securities are not symmetrically distributed. An individual share can only lose 100% of its value but can gain more that 100% of its value. The following figure illustrates this point. In any positively skewed distribution, the median return will be less than the average return. By definition, the median splits the distribution in half, implying that 50% of securities must perform worse, and 50% must perform better than this value. Over the period considered, the median per annum return for the 40 largest South African equities was 4.8%, while the return of the Top 40 Index was 8.7% pa — effectively rewarding the investor with a 3.9% excess return per annum.



All things considered, the benefits of investing in an average actively managed portfolio makes it difficult to justify the risk of selecting a handful of individual stocks. An investor who chooses a well-structured portfolio benefits from the statistically larger likelihood of greater performance, as well as the risk reducing benefits of diversification and intelligent portfolio construction.

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