New indicators to help investors manage portfolio diversification

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A new set of indicators to help investors allocate, monitor and manage a portfolio's stock diversification have been identified in research by Ghassan Chammas of Rotterdam School of Management, Erasmus University (RSM).

Indexes around industry or poverty concentration and specialization, which are widely used by economists in social welfare, have been adapted to suit investment portfolios. This, according to the study, provides enhanced information and better description of a portfolio.

These can support investors in their allocation decisions: what stocks should they buy and sell, and how much should they invest in each stock?

Ghassan Chammas says: "Concentration and specialization indexes have rarely been applied previously in investment techniques. By using them it will offer investors the option to acquire an understanding on their wealth distribution, according to a set of attributes, and to better manage and monitor investment. Investments are continuously reallocated, so depending on the strategy, a portfolio might unwittingly become more concentrated or specialised over time.

"By relying on the normal approach of statistical measures in managing an investment portfolio that is based on a distribution assumption, they are prone to estimation-error. What these numbers do not reveal is the extent to which investments are skewed towards a relatively small number of stocks, or a particular industry or country.

"The measures I am putting forward are estimation-error free and are designed to add and not replace current methodology, since they are a direct measure and not a distributional approximation, such as expected return, average return or standard deviation."

Chammas says that specialisation can be calculated for any attribute of a particular stock. And the more attributes under consideration, the clearer the picture. For example, the indicators might show that investments are concentrated in three of its 15 stocks, and is specialised in pharmaceutical firms in Japan and mining firms in Malaysia.

He stresses that concentration and specialisation is not necessarily a problem, as long as investors are aware it is happening and are not blindsided by it. In fact the research relays the concentration and specialization level of a portfolio to the pretension of the investor.

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