International Journal of Accounting Research

Chadha, Int J Account Res 2016, S1
http://dx.doi.org/10.4172/2472-114X.S1-004

Research Article Open Access

Is International Investment Diversification Prudent to Either the Individual or Corporate Investor? Why?

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Abstract

A credit crisis was created when several investment banks collapsed, acquired, and left the investment banking industry due to internal inancial trouble in 2007-2008. On October 3, 2008, the Troubled Asset Relief Program (TAR P) was signed into law to strengthen the inancial sector and avoid the effects of a recession.

This paper examines whether the investment portfolio diversification is beneficial to both corporate and individual investors. International diversification is prudent for both individual and corporate investors due to its ability to maximize returns and lower risk. The paper concludes that both individual and corporate investors should engage in international diversification and there are no set rules or strategies to generate profits. Practicing prudence will keep the portfolio safe from all possible risks.

Keywords: Troubled asset relief program; Unsystematic risk; Financial catastrophes; Standard deviation

Introduction

Investment portfolio diversification is defined as a way to eliminate or minimize the unsystematic risk. The golden rule adopted by investors was never to put more than 5 -10% of liquid investment assets into any sfingfle finvesftmenft [1,2].

Good decision-making is possible only when the investor knows that the portfolio's expected return is sufficient to the task and that the shortfall risk is within the bounds of prudence. Compound return, which determines the portfolio's terminal wealth, is approximated, by:

Compound returns = average return -1/2 (variance of return) [3].

Mitigating variance or, standard deviation of returns therefore makes the wealth building process more likely to succeed by emplying risk control strategies [3].

Prudent investment practices are necessary when failure and corruption exist in the financial industry intermediaries and fiduciaries holding individual investors' securities [2]. Prudent investing requires that the risks and returns of the portfolio align with concrete investor objectives rather than with abstract 'beat-the-market' goals. Investment strategies designed to maximize expected return may prove to be either financial bonanzas or financial catastrophes. These prudent strategies are designed to enhance the probability that a critical goal will be successfully met and are, suitable for most investors [3].

History

The Prudent Man Rule has been the standard for risk management of investment portfolios for over 120 years. It originated back in 1830s because of a judge's decision in a lawsuit over the estate of John McLean in Boston, Massachusetts. Harvard and Massachusetts General Hospital promptly brought suit against the Trustees for mismanagement of the McLean portfolio. In rendering his decision, the judge concluded that the trustees had conducted themselves "honestly and discreetly and carefully, according to the existing circumstances, in the discharge of their trusts".

John McLean had died in 1823 and left $50,000 in trust to his wife. After her death in 1828, the estate was valued at $29,450, which was to be distributed to Harvard College and the Massachusetts General Hospital.

1896-1929: Investment banking was in its golden period with JP Morgan and National City Bank as the market leaders sustaining the financial system. Excess market speculation by banks using Federal Reserve Loans to boost the markets resulted in the market crash of 1929 causing the Great Depression [4].

1929-1970: The nation's banking system was in a mess with 40% of banks either failing or forced to merge. The Glass-Steagall Act was enacted by the government to separate commercial banking and investment banking [4].

1970-1980: In 1975, the trading commissions collapsed and profitability declined. The development of an integrated investment bank providing sales, trading, research, and investment banking under one roof began to take root giving rise to the financial products that provided beneficial returns [4].

1980-2007: An IPO boom conquered the view of investment bankers as the 1990s cut down. The enactment of the Gramm-Leach-Bliley Act (GLBA) in November 1999 effectively permitted the mixing of banking with securities and insurance businesses under the Glass-Steagall Act [4].

The investment philosophies are a way of thinking about markets, how they work and the types of mistakes that are committed by the investor due to individual behavior and consist of: a) Market Efficiency, b) Tactics and Strategies, c) Market Timing Vs. Asset Selection, d) Activist Vs. Passive Investing, e) Time Horizon, and f) Co-existence of Contradictory Strategies [5].

Current statement

Today's market environment presents a multitude of challenges

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Received May 10, 2016; **Accepted** June 30, 2016; **Published** July 04, 2016

Citation: Chadha P (2016) Is International Investment Diversification Prudent to Either the Individual or Corporate Investor? Why? Int J Account Res S1: 004. doi:10.4172/2472-114X.S1-004

to advisers that necessitate embracing a new approach to portfolio construction. The markets are more complex, fast moving and unpredictable; however, investors' general objectives are to increase the value of portfolios and reduce the risk of losses. In diversification, when one asset declines in value, other assets increase protecting against overall losses [6].

In an environment where volatility and extreme events like the market shocks of 2001 and 2008, new methodologies of diversification are mandatory. The best way to measure loss is through drawdown. Focusing investors' attention on drawdown and thresholds for loss simplifies the concept of risk and makes it easier to measure and manage [6].

The traditional mix of equities (large cap value, large cap growth, small cap value, small cap growth) is popular because it works most of the time. Unfortunately, during extreme down markets, significant portfolio losses occur which are hard to recover. Strategies that utilize a tactical approach offer more for managing risk. An adviser who builds a diversified portfolio (active, passive, or both) uses a single method to reduce the client's exposure to systematic risk [6].

When it comes managing risk, the principle of diversification still applies and must be approached in a much more in-depth and analytical way on a client-by-client, investment-by-investment basis. With the enormous variety of investment products available, achieving up-and-down market diversification for each individual client can seem like a daunting task, but thanks to the power of emerging technologies to drive efficient, in-depth research and analysis [6].

Managers and strategists have embraced the possibilities and use new approaches in technology to aggregate market signals in the tactical universe and automatically use that data to adjust their positions. This "in-sample experience" i.e., tracking models and running conceptual strategies in real-time, is an extremely valuable analytical tool made available by recent innovations [6].

Environmental statement

The financial crisis has increased public awareness about environmental issues, corporate governance and business sustainability. Corporate and individual investors are focusing more closely at 'ethical' or socially responsible companies. Greater emphasis by investors is placed on the importance of the environmental, social and economic consequences of their investments. A managed fund with investments in ethical companies can provide investors with an assurance that each stock has been carefully researched and screened before inclusion in the fund [7].

Discussion of Facts and Issues

International investing requires a more global outlook when it comes to decision making rather than dealing with domestic markets. Additionally, diversification provides investors with higher returns when investing in a longer duration assets rather in one-year duration ones. Prior studies have shown that entrepreneurs are willing to adjust their strategy and take risks in the pursuit of profitable opportunities, thus contributing in a long-term economic growth.

According to Malkiel et al. [8] the volatility of individual stocks has risen over the past few decades, while the correlation among stock returns is falling, resulting in no change in market volatility. The only way to truly minimize the risks of stocks is by owning the whole market as per Modern Portfolio Theory. The behavior of individual investors is being influenced mostly by their educational level rather than by their financial background or by other criteria. The sophisticated investors are more likely to hold foreign equities than investors from a common sample of stockholders.

Capital Asset Pricing Model (CAPM) is followed by international capital markets to measure the riskiness of securities and for conducting financial valuations by consultancy firms [9]. This determines investor's return on a given risk. Investors take a position out of an analysis of domestic assets and global portfolio while hedging against currency risk [9]. However, Blake et al. [10] suggests that having a passive asset allocation policy, funds would generate more returns that are favorable.

Analysis of Facts and Issues

The main advantages of investment portfolio diversification to both corporate and individual investors is that risks are minimized by selecting different assets and reduce the volatility of the weakly correlated assets in the portfolio [11]. This helps international exposure because different economies run on different market cycles. Increase in globalization leads to increased profits, dividends, and stock prices [12].

However, the disadvantage of diversification is reduction of return of the portfolio. It cannot ensure profit or loss [11]. Limiting to local economies will lead to less benefits and returns. Foreign stocks pay irregular dividends once per year. Others pay dividends twice per year, by paying an interim and a final dividend. Few international companies follow a managed dividend policy like US companies while others pay in fluctuations. Owning foreign stocks include steep withholding taxes on distributions and could vary country by country. Some countries do not levy withholding taxes on dividends that are received in retirement accounts [12].

Conclusions

To conclude, international diversification is important in investing whether it's at individual level or corporate. Globalization of investments in today's economy is an ongoing trend and investors are ready to take risks. Both corporate and individual investors follow the market news around the world and make decisions without any financial knowledge or background. There are no set rules or strategies to generate profits. Depending on the market, some generate gains without diversification of portfolio. Bull markets can make investors double dip their diversification, increasing fees with virtually no increase in diversification benefit. While bear markets can break, historical correlations break down and could lead to losing on both the growth of portfolio and its protection as well [13]. However, when handled well international diversification has the potential to bring benefits to either the individual or corporate investor [14,15].

Recommendations

The principles of prudence, and the requisite duties prescribed by Schultz Lawson is:

1. Decisions about individual assets must be evaluated in the portfolio context [3];
2. Risk and return are directly proportional [3];
3. Safe diversification is fundamental to risk management [3];
4. Current income must be balanced with protection of purchasing power [3]; and
5. A prudently managed portfolio avoids unjustified expenses [3].

Winans [13], suggests that keep holdings to a manageable number of investments; don't buy and hold commodities and keep trading them; invest in foreign stocks and funds as US companies generate 50% of their revenue from foreign investments; invest in strong businesses and don't focus on market capital; and lastly, buying illiquid and high fee investments both perform poorly over time [16,17].

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This article was originally published in a special issue, **Collection of Finance Research** handled by Editor. Payal Chadha, Swiss Management Center University Zug, Kuwait