Prudential Investment Managers
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Are you avoiding the beginner investor's biggest mistake?

So, you've started investing and decided to do it yourself. No financial adviser to pay, nobody telling you what to do with your money. Sounds promising? But with no one to guide you, you could be I making one of the biggest mistakes a rookie investor can make: not diversifying enough.

A 2019 study by the University of British Columbia's Sauder School of Business found that less experienced investors don't diversify their portfolios enough – and as a result they put themselves at serious financial risk. In fact, the study found that many beginner investors would actually be better off just choosing stocks completely at random instead of painstakingly putting together their insufficiently diversified portfolios!

The researchers asked study participants to create portfolios using tables of previous stock returns. They found that investors who lacked sufficient investment knowledge tended to unknowingly choose what's known as "positively correlated" assets, which fluctuate in value together. "An amateur investor might buy stocks in lumber, mining, oil and banks, and believe they are diversifying because they're investing in different companies and sectors," said study co-author David Hardisty. "But because all of those equities tend to move in unison (or put differently, they have a positive correlation relative to each other), it can be quite risky, because all the assets can potentially plunge at the same time."

Why did novice investors behave like that? Hardisty says it's because correlated assets seem less complicated and more predictable. "If it seems predictable, it seems safer and easier to track," he explained, "whereas if you have a combination of assets that all go in different directions, it seems chaotic, unpredictable and riskier."

So in building their portfolios, inexperienced investors tend to pick a wide range of seemingly unrelated assets, and get the balance wrong. This results in higher investment fees, a less resilient investment portfolio in different market conditions, higher risk and inevitably, weaker performance.

The value of a skilled asset manager should be obvious by now. Experienced investors know how to design a well-diversified portfolio that includes negatively correlated assets (which move down when others go up) or uncorrelated assets (which move up and down independently of the others).

That's the key to effective diversification: balancing a wide range of underlying assets whose values react differently to changing market conditions. This allows you to hedge your bets and reduce your risk of losses. On average and over time, a well-diversified investment portfolio is more likely to generate higher long-term returns and reduce risk during different economic cycles.

As Hardisty explained: "If you don't diversify, when one asset does well the other ones are also going to do well. But if one does badly it's likely the others will all do badly – and in investing, you want to avoid those worst-case scenarios."

If diversification of assets sounds complicated, that's because it is, especially if you lack the time or the investment knowledge to do the research yourself: and that's why smart investors know when to go it alone, and when to trust an investment manager.

At Prudential, we offer a range of multi-asset investment portfolios that diversify across a range of different asset classes, sectors and geographical regions. This helps to protect against the downside and add potential to the upside of investor returns. To find out more, visit the Our Funds section of our website, or try our Fund Selector tool to find out which Prudential fund is best suited for your investment objective, risk profile and time horizon.

For more information, speak to your financial adviser or call our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.