RISK AND RETURN

Market Portfolio

The market portfolio is a theoretical concept: It comprises every type of asset one can invest in, weighted relatively to the value of the entire universe of investment possibilities. – The concept is not only relevant in benchmarking the relative performance of an asset. It also helps to distinguish risks into such which have their origin in the market environment vis-à-vis those which originate in an asset itself.

Not surprisingly, the earnings volatility and risk profile of a mature food company differs markedly from that of a luxury goods company. Latter is characterized by a much more cyclical performance dynamics, in essence amplifying the ups and downs of the overall economy. - Even though a food producer and a luxury goods manufacturer may have quite distinctive risk profiles, there are risks which will impact both of them: If, for example, global economic growth slows, then both firms can be expected to report weaker financial results. Even though, the luxury goods manufacturer is expected to suffer more.

On the other hand, certain risks will specifically only impact a certain firm: For example, the risk that the luxury goods company´s new facility for the production of handbags runs behind schedule. Or that the food producer´s recently appointed management may turn out to be weak. - Further, certain risks will be linked to a specific industry sector only: The luxury goods company, like other competitors as well, will lose revenues from much cheaper fake design products or the food producer will be negatively impacted by a disastrous harvest resulting in higher production costs.

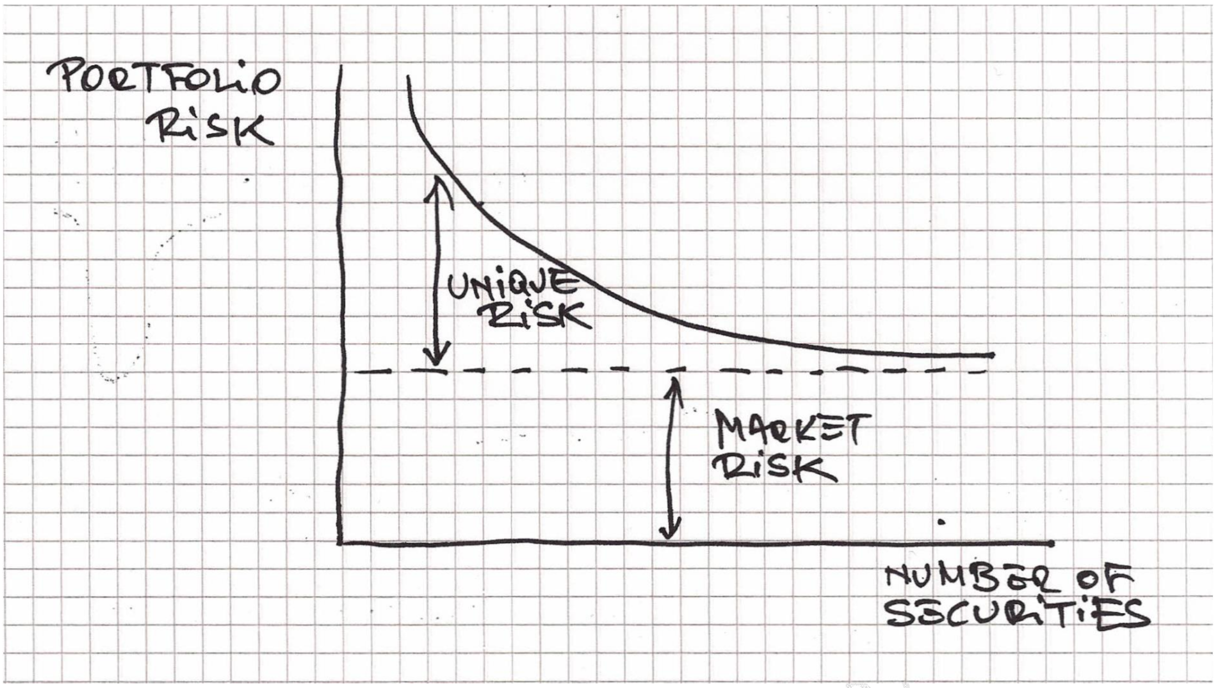
This risk categorization of such directly affecting a firm or a certain industry and such which are general, market-wide and therefore impact all firms and industries – and in consequence: all stocks - is important.

Let´s assume someone decided to invest and build a portfolio with a focus on the luxury goods industry: The investor buys next to stocks of a luxury handbag manufacturer also such of a high-end automotive manufacturer, a prestigious champagne producer, an haute-couture fashion designer, a top-notch boutique hotel, an exclusive jewelry chain and others. Whilst certainly exposed to the luxury goods sector, the investor has at the same time diversified risk – as well as return - across several companies: If, for example, the wine harvest failed this year and therefore the champagne producer suffered losses and performed badly, then this specific risk would be mitigated due to the investor´s diversified portfolio: Risks linked specifically to a certain individual company can be significantly diversified away by investing in a portfolio, even if this were (only) industry-focused.

An investment portfolio can of course be diversified even more broadly, such as across different industry sectors and geographies. In such a case next to firm-specific risks also industry-specific risks can largely be diversified away.

However, there is a limit: Whilst empirical and statistical research indicates that a well-diversified portfolio of around 15-20 different stocks will basically eliminate all major company- and industry-related risks, the so-called market risk will remain: It cannot be diversified away. Market risk combines a whole range of risks which affect the performance of all industries and firms and therefore the financial markets - and along them all stocks. A good example for this is a macroeconomic-induced shock.

An example for a well-diversified portfolio – alas: market portfolio - is any global stock index. Such an index may be composed of hundreds of stocks, such as the S&P 500. An index is an important tool for any investor, as it may serve as a benchmark for an investment strategy in regards to both, risk and return.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