

Spotlight on Concentration Risk

Concentration risk is the chance that a big bet can go wrong. Anyone who owns a business understands concentration risk. Imagine that you own a plant nursery. You make money by raising plants and selling them. Your business has many features in common with the other businesses in the neighborhood. If the overall economy is in a slump, customers will cut back on a variety of purchases, from zinnias to roasted chicken. If the city removes parking spaces, you all suffer. If there is a fire in the shopping district, all the merchants could lose their shops. But if there is a beetle invasion, only you are at risk for losing your inventory. We call risks that are common to many businesses systemic risks, and those that are particular to one type of business we call idiosyncratic risks.

Now, imagine that you are a bank lending money to all the merchants on the block. You will lend even if your borrowers face some risks. That is the business of banks. When possible, though, you will try to mitigate the systemic risks you face. For example, your bank requires all its borrowers to carry property insurance. Your bank also demands evidence that its borrowers have strong business models that generate cash flow. The insurance requirement and credit checks mitigate systemic risk for your bank. How does your bank mitigate its idiosyncratic risk? Diversification.

If your bank makes loans to 100 businesses, chances are that only one of them will have its business models threatened by pests. You will still be in business if one of your borrowers defaults because of beetles because your 99 other borrowers will carry on as usual. We say that your bank has a diversified portfolio because it has limited its exposure to idiosyncratic risks.

Contrast these two approaches:

Concentrated: Buy \$10,000 of stock in a biotech firm

Diversified: Buy \$10,000 of stock in the Standard & Poor's 500 index.

The biotech investment could win big if the firm successfully markets a blockbuster drug. If its only promising drug fails an FDA test, however, the firm could go under and you could lose your entire investment. Idiosyncratic risk can yield huge rewards, but it can also take a dramatic toll.

The S&P 500 index contains the stock of 500 companies. Chances are good that not all of them will fail at the same time. Overall, the S&P 500 should have more moderate performance than the biotech company. The idiosyncratic risk of the individual companies blends down to almost nothing if you have enough assets in combination.

This is not to say that a portfolio of many investments has no risks at all. There will still be common factors, like the strength of the economy or the level of interest rates that will affect virtually every business. Diversification greatly reduces idiosyncratic risk, but it does not reduce systemic risk.

Interestingly, some risks that are common to one asset class may not affect another. Consider what happens to equities when oil prices rise. Because many companies use oil as an input to production, rising oil prices increase prices for manufacturers. If the manufacturers cannot pass along a price increase to their customers, then rising oil prices will cut corporate profits. We would expect stock prices to fall.

What if we added investments in commodities to the portfolio? Because oil prices are rising, the commodity investment should gain in value, all else equal. A portfolio with both stocks and commodities would be less responsive to changes in the price of oil than either equities alone or commodities alone. Adding commodities to an equity portfolio diversifies the portfolio and reduces concentration risk.

What about bonds? Bond prices respond mostly to changes in interest rates and inflation expectations. How would bonds respond to changes in the price of oil? This depends on whether the price increase creates inflation. If the overall level of prices and wages is stable, then inflation will not be too big a threat, and bond prices will be independent from oil prices. If, however, rising oil prices lead to increases in the prices of goods and services, then inflation will be on the rise and bonds will fall in price. So, bonds can sometimes be diversifiers for an equity portfolio, reducing the risk of concentrating in equities.

Investing in a portfolio of many securities protects against idiosyncratic risk. Adding bonds and commodities to a portfolio helps reduce some systemic risks. A diversified portfolio of equities, bonds, and commodities does for the investor what the portfolio of 100 loans, property insurance requirement, and credit checks do for your bank. Diversification helps reduce the risk of concentration.

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