Diversification Benefits for Entrepreneurs with Multiple-Stock Portfolios

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Abstract

Risk Diversification Benefits of Multiple Stock Portfolios: What does it buy the Entrepreneur in Jamaica? This is a valid question considering the size of the Jamaica Stock Exchange (JSE) and the similarities of the companies for which stocks are traded. Portfolios are randomly simulated with increasing number of stocks in order to evaluate the benefits of adding stocks to a non-diversified portfolio in terms of risk reduction. The results show that there are benefits to be gained from portfolio diversification on the JSE. However, in some instances these benefits appear questionable.

Key Words: Entrepreneurship, Diversification Benefits, Muti-Stock Portfolio,

Introduction

Several papers have highlighted the risk benefits of multiple stock portfolios, and have indicated that portfolio risk is inversely related to the number of stocks held in a portfolio. The main reason for this is the fact that some companies' stock returns may be inversely related and therefore when one is declining another may be increasing, which in turn results in a stable average return.

Much of this research has been done in developed countries with larger and far more developed stock markets. The Jamaican context is different, in that it is much smaller with far fewer stocks. Most stocks seem to be related and may move in the same direction (affected by same negative or positive shocks), hence decreasing the effectiveness of diversifying amongst companies.

The focus is on entrepreneurs as for many years investing in equity or debt has dominated establishing actual businesses due to high returns on both equity and debt. That is, entrepreneurs invest in equity to take advantage of the maturity of well established firms rather than enduring the teething pains which accompany a start up. Additionally, the generally high cost of doing business in terms of bureaucracy and the level of crime among other things has made investments in government debt –which generated returns in the region of 20 % in the decades of the 80's, 90's and 2000's – a very attractive alternative to traditional entrepreneurial pursuits.

The results are similar to that of previous research done in developed countries with more developed stock markets. 'Adding only a few stocks to a non-diversified portfolio produces significant risk reduction' (De Vassal 2001).

Literature Review

De Vassal (2001) evaluates the risk diversification benefits of adding stocks to a portfolio by analyzing stocks on the Russell 1000 within a bullish time period and shows that risk (dispersion of returns) is inversely related to number of stocks in a portfolio. He concluded that increasing the number of stocks significantly reduces the risk of underperforming inflation and the stock exchange.

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