Financial risks diversification and Insurance

International financial markets in recent months have highlighted how widespread volatility and instability can put at risk the value of investments by businesses and private citizens, who have struggled to find "somewhere safe" for their savings. In this light, a traditional solution has always been to rely on "diversification."

Now, what exactly is intended by "diversification"?

A consolidated strategy to reduce risks is to diversify them. Through the **"diversification of risks"** you are moderately exposing yourself to several diverse risks rather than to a single great risk thereby restricting damages in the occurrence of a loss.

Diversification from an "insurer" point of view

For an **international insurance company**, the "diversification of risks" takes on an even different meaning. In fact, the traditional activity of an insurance company requires it to have the ability to aggregate the individual risks of policyholders and to create added value for the policyholders themselves as well as for the market. In exchange for the payment of a premium, policyholders are to be compensated for the financial consequences of a loss, which they would otherwise be unable to sustain, by transferring the related risk to an authorised third entity, which can then define an equitable pro capite cost at the same time drawing a financial return for its entrepreneurial activity. This is what is intended as the **"social function"** of insurance.

Thanks to **international** diversification it is then possible not only to enlarge the homogenous risk groups but

also to ensure that you aren't too overexposed to a single country, as in the case of insurance against **natural catastrophes**.

A further technical instrument is represented by **"reinsurance"** that allows to keep the system in balance by transferring part of the risks to specialised companies.

Diversification from an "investor" point of view

From the point of view of an investor – which is, of course, also the point of view of an insurer – diversification has a more specific meaning. Diversification in this case refers to the possibility for investors **to reduce the investment risk** by investing in securities or in various classes of non-correlated assets while maintaining investment returns at the same level. **Low risk – high return** investment is, of course, the ideal kind of investment, however in the real world investment returns increase in relation with the underwritten risk. Therefore, the fluctuation of the yield of a given security – i.e. its volatility – is **a measure of the risk**.

Diversification can be achieved at **multiple levels**, for example by investing in:

- diverse securities in the same market or class
- diverse classes of securities
- diverse geographical areas

Diversification among securities

Investors may decide to distribute investments in the shares of companies operating in **various sectors** within the same share market.

The benefits of diversification as applied to a portfolio of securities were highlighted by the theory outlined by **Harry Markowitz** according to which investors can select an optimised **risk-investment return** by combining a fully diversified portfolio with a security that has been considered **risk free**. On the basis of this theory, the greater the advantages generated by diversification the lower the correlation of the investment assets present in the portfolio.

Transaction costs

Considering shares in European markets, the cost of a financial transaction for an institutional client can fluctuate between 0.04% and 0.10% while for a private client these costs can rise by at least 0.10% over those mentioned earlier. In addition, the bid-ask **spread** for a bond is an additional cost that could result being more convenient for **institutional investors** who, in view of the volumes involved, can negotiate terms that are better than those applied in the market at that given moment.

Diversification among investment asset classes

A higher level or degree of diversification can be achieved when investors further diversify between investment asset classes, namely **shares, bonds, real estate bonds, commodities, private equity**. Nevertheless, several recent studies have shown that the benefits of diversification between diverse asset classes may be restricted during declining markets.

Geographic diversification

Geographic diversification offers the possibility to invest in various markets and, therefore, in securities that are exposed to **political and market risks** in a number of different countries and whose market performance is basically not correlated with the investor's domestic market of reference. The possibility to invest in international markets is restricted by the ability to effectively access reliable information relating to international investment assets. Accessing such information generates additional costs while the limited number of transactions is a further obstacle to investment liquidity.

And, finally, the interconnectivity of financial markets and the effects of globalisation have further undermined the benefits of diversification in view of the **growing correlation of markets worldwide**.

This is the scenario that we have witnessed over the past few months in Europe. The sovereign debt crisis, which had initially affected some of the so-called "peripheral" Eurozone countries, namely Greece, Spain, Portugal, Ireland, successively spread to the other countries that were believed to be more reliable, thereby partially reducing the diversification benefits for those who invested in the state bonds issued by those countries.

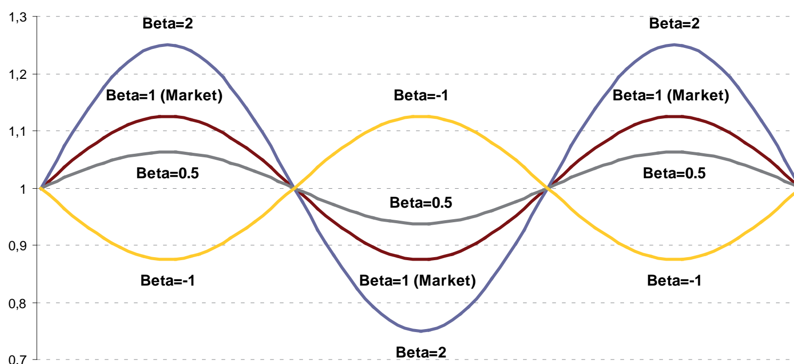
Diversification: a difficult activity for private investors

An additional factor to be considered are the **transaction costs** deriving from the acquisition and sale of financial instruments. Either fixed or variable, these are costs that affect to a lesser degree institutional investors who are in a position to pool much larger volumes than the individual investor. A case in point is the normal practice applied to common investment funds where institutional players do not pay "opt-in" or "opt-out" commissions unlike private investors.
Besides those relating to transaction, other **costs**, too, must be considered. Management, **legal and administrations** costs are also in this case more convenient for the institutional than the private investor.
In a nutshell, the complexity, as well as the costs associated to diversification, makes it an activity that is often out of bounds for private investors. On the contrary, institutional investors and other players who are in a position to operate in diverse and global markets – investors, that is, who can rely on adequate

Volatility

To understand **volatility** – i.e. the variation in the value of a security with respect to the market – operators utilise a parameter known as the **"Beta"**.

- **Beta = 1**: the share moves in line with the market.
- **Beta > 1:** the share boosts the market offering returns that are higher when the market is moving upward, and lower when the market is falling.
  A good example of this investment class is the automotive industry where purchases increases when the market grows but drastically fall when there is a crisis.
- **Beta between 0 and 1:** a share that although affected by the economic cycle is less volatile than the market itself (a case in point are agribusiness companies)
- **Negative Beta:** the share is in countertendency with respect to the market, overperforming at a time when the market is experiencing a downturn. These so-called "anti-cyclical" stocks are in a position to provide optimised diversification benefits in the portfolio, but are generally quite rare. Examples of these stocks are large consumer goods that become the focus of consumers at a time of economic crisis but are neglected when the overall picture improves. Utilities and power companies also generally perform well when the market is declining.



organisational structures, human resources and processes – can seize the opportunities arising from this technique to protect their investments.
On the other hand, it should also be observed that "too much diversification can be ineffective." For a company, excessive diversification may, in fact, result in a disproportionate increase of **coordination and management costs,** such as those, for example, arising from the collection and processing of large quantities of information. Besides, an approach focused exclusively on diversification may lead a company to **neglect other aspects**, such as the valuation of how some securities appear to be over- or under-valued in the market or the intrinsic value of the security itself.

Optimising diversification: Generali's approach

It should be observed that the setting of the optimised level of diversification is an **essential and strategic choice** for an enterprise as well as for the single investor.
With assets under management amounting to approximately € 471.2 billion, of which €315.5 billion in own assets, the Generali Group pursues an adequate and prudent investment policy where diversification and risk-return optimisation are key features.
Requiring to provide financial backing to its insurance and asset management operations over a broad time horizon, besides providing adequate returns to shareholders, the Generali Group operates on a global scale. Although Europe is its principal market of operations, Generali can rely on structures in over 60 countries worldwide, diversifying its investments by geographical areas, product lines and asset classes.

Mr. Setbon, Group Chief Investment Officer, explains: *"The Group's international presence offers a broad range of investment opportunities in the markets we operate. By operating on a global scale we can seize such opportunities not only at home and in Europe but also in emerging markets, and we are at the same time in a position to implement sophisticated asset management structure which allows us to focus our investment policy across geographies and asset classes (shares, bonds, real estate, private equity…)".*

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