Release date

20 April 2024

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How many funds should investors hold?

Investors are always advised to spread the risk. Hence, they should hold several different funds. But how many funds would be optimal?

Determining how many funds investors should hold in their portfolios is difficult. There is no 'magic number'. First, investors should evaluate their risk appetite, desired period, and financial situation. For example, investors with a higher risk tolerance seeking potentially higher returns may allocate more money into funds investing in shares of smaller companies, funds with risky strategies, exposure to riskier assets, etc.

Those who prefer lower-risk investments can buy more funds to invest in government and corporate bonds. Whether investors select actively managed funds or passive funds, they should be prepared to hold them for at least 4-5 years, and even longer.

Investors need to consider a) the asset classes invested by each fund, b) the geographic exposure offered by each fund, c) the sector (IT, Healthcare, etc.), and d) the risk profile of the fund. Investors are advised to find out the key features of each fund from their KIIDs, Factsheets, and Prospectuses.

Some funds offer various strategies, asset classes, and regions. More importantly, investors should understand what they are investing in. For example, if each fund holds 30-50 underlying investments, then if someone invests in 20 different funds, he/she could have exposure to as many as 1000 different positions. In this scenario, the problem is that some investments will be duplicated.

The idea is to avoid holding funds with the same investment objective and similar holdings. In addition, having too many funds can make it difficult to track them. If some funds perform strongly, they will become a larger part of your portfolio, so you may need to rebalance it. So, ongoing monitoring is key.

Investing in a fund of funds could help those who want to achieve diversification by investing in just a handful of funds. Such an option could be a fund of hedge funds specializing in credit and arbitrage strategies. Through such a fund, investors also get exposure to various managers and to asset classes that have low correlation with the markets. Most investors would be unable to select and invest in the underlying hedge funds on their own. Firstly, because of the expertise required to select hedge funds and second because of the minimum investment amount required by each fund.

Of course, there are different types of multi-asset funds, which have different investment objectives. The right variety of asset mix for you will depend on your attitude to risk. Taking on more risk can potentially mean higher returns, but there is also a greater chance of losing money. On the other hand, less risky investments may provide you with more secure returns (even though they too can fall in value), but these are likely to be lower.