



Fisher Funds

Investor Education Centre

*Making investing enjoyable, understandable
and profitable...*

Diversification or Diworsification?

02/05/10

As portfolio managers, we are keenly aware of the merits of diversification. We know that by diversifying our investors' money across a number of different investments, we can reduce the overall risk of one particular investment being a disappointment.

Diversification by a business can also be a good strategy, but there are some catches.

A company generally chooses to diversify in order to increase revenues (and hopefully profits) from new markets and new customers.

A company whose existing business is reaching maturity or has limited growth potential might diversify into new markets to give it new growth opportunities. Or a business might look to leverage its existing business by launching new products that are complementary to its existing ones.

A diversification strategy is not without risks. Going into an unknown market with an unfamiliar product introduces uncertainty. The company can't rely on the skills and expertise developed in its core business, because it is all new territory.

Veteran investor Peter Lynch talked about 'diworsification' in his book *One up on Wall Street* where he suggested that a business that diversifies too widely, risks destroying their original business because management time, energy and resources are diverted from the original investment.

I remember back in the 1990s when Michael Hill International diversified into the shoe business. Their logic was that they had been successful in selling jewellery and they understood the buying habits of their, mainly women clients. It therefore made sense that they could apply their knowledge to selling shoes, which like jewellery, are a discretionary purchase for women. They quickly learned that staff skilled at selling jewellery, are not necessarily good at selling shoes. To give them credit, the company quickly realised their mistake, closed the business and went back to what they were good at.

This week Pumpkin Patch announced the launch of a new brand, targeted at the 'playwear' category of childrenswear.

The thinking behind this strategy of diversification is that it will allow Pumpkin Patch to have a presence in the mainstream, everyday kids clothing market whereas their other brands, Pumpkin Patch and Urban Angel are more at the fashion end of the market, with a higher level of pricing.

It would be easy to react negatively to this diversification on the basis that 'if it ain't broke, don't fix it'. Pumpkin Patch is doing well with its core business and is emerging well from the global financial crisis which wreaked havoc on their US operation in particular.

Is this an example of diworsification? I don't think so, because it is really about leveraging the existing business of Pumpkin Patch rather than detracting from it.



Fisher Funds

Investor Education Centre

*Making investing enjoyable, understandable
and profitable...*

Pumpkin Patch makes and sells children's clothing. This diversification is about selling a slightly different sort of clothing to broadly the same market that the company already knows and understands. Selling an embroidered pair of jeans under one brand and a plain pair of track pants under another makes more sense than selling a diamond ring in one of your stores and a pair of stilettos in another.

Making investing enjoyable, understandable and profitable...