Let Diversification Do Its Job

By CARL RICHARDS

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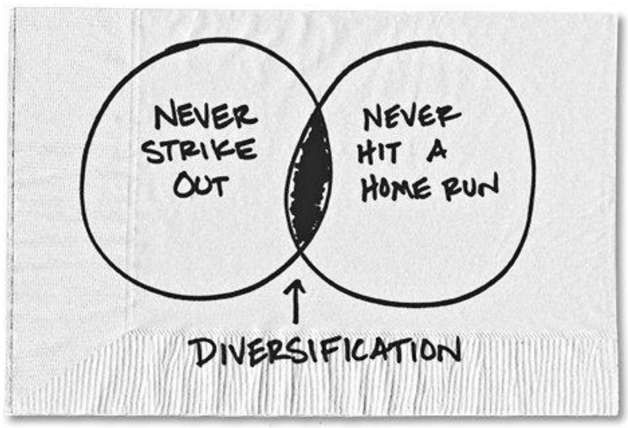
Investors typically set up a diversified investment portfolio to reduce their risk. Just hold a good mix of different kinds of stocks, along with some bonds and cash, and your problems are over.



RIGHT? Not exactly

Diversification comes with its own risk. But before we get to the risk, let's talk about how we define this term in the first place.

When people say diversification, they're often talking about two separate things. First, there's equity diversification where you split up the portion of your money invested in stocks among big ones, small ones, undervalued ones, international ones and so on.

The idea behind this strategy is that you can reduce your risk, since different types of stocks often behave differently depending on market conditions.

Sometimes, it works. Dimensional Fund Advisors reported that in 1998, the large company stocks that make up the S.&P. 500 gained 28.6 percent while small-cap value stocks lost 10 percent. Then in 2001, the S.&P. 500 was down 11.9 percent, while those same small-cap value stocks gained 40.6 percent.

Since it does help sometimes, equity diversification is a useful strategy. Do it. But you have to understand that equity diversification sometimes fails to deliver exactly what you expect it to and often fails when you need it most.

We saw this in 2008-2009, when almost every type of investment fell. Granted, diversification would have saved you from making a mistake like putting everything in Lehman Brothers stock, but you still saw equity holdings plummet.

If you think back to that time, you will most likely remember hearing people say that diversification was broken, that it no longer worked. I remember thinking that myself.

But remember, when that happens and people start running around again saying diversification doesn't work, they're talking about equity diversification. There's another, more important type of diversification: the way you split your money between stocks, bonds, cash and other investments.

This portfolio-level diversification is the primary lever to help you manage the risk and return in your portfolio. Each type of investment plays a different role:

- ***Stocks provide the growth.***
- ***Short and intermediate bonds provide more safety and a little income.***
- ***Cash is there for liquidity and to protect your money.***

The idea is to balance these investments in a way that gives up some higher returns in exchange for lower overall risk. Essentially, you've given up the opportunity to hit home runs for the benefit of never striking out.

With that out of the way, let's talk about the risk of diversification.

Whenever you diversify, if you've done it correctly, there will always be something in your portfolio that you're in love with and something that you want to dump (or will at least be the source of concern, as bonds are now in some circles). Some investment or asset class will be doing fantastic compared to the rest of your portfolio, and something will be doing much worse than everything else.

The trouble is, you never know when all of this will change. The thing you want to buy more of now will someday become the thing you want to sell.

Think back to the example from 1998. Having lived through it, I can tell you it was awfully tempting to move all your money out of small-cap value stocks and into large-cap stocks. But that would have been a terrible decision given how well small-cap value stocks did just two years later.

The same is true when you diversify among stocks, bonds and cash. When the stock market is tumbling like it did in 2008, you want to move everything to cash, and it's really hard to keep money in bonds or cash when the stock market is having one of those great years.

But here is the point. The risk of diversification is that you will bail on it as a strategy at exactly the wrong time.

That feeling you get — the one that says, I wish I could dump this lame investment so I could buy a whole bunch more of this incredibly hot one — can get you into trouble fast. The temptation is greatest when it would be the most catastrophic for you to succumb.

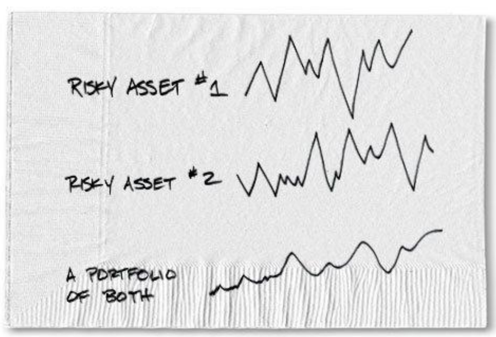
But that feeling is actually telling you that you've done the right thing: You're diversified. So remember that when the current fad ends and today's rejects come back into style, you'll be okay. And you'll be awfully glad you didn't give in to the temptation to give up on being diversified.

The next time diversification appears to not be working, remind yourself that it is a long-term strategy that can't be judged on your short-term experience. In other words, just because something isn't working right this minute — or even right this year — doesn't mean it's broken. So instead of thinking, "I am a rocket scientist and I can come up with something better," just let diversification do its job.

Then go for a hike in the mountains instead of sitting hunched over the sell button on your broker's Web site.

Why (and How) Diversified Investors Win

By CARL RICHARDS September 6, 2011,



Diversification remains one of the most fundamental investing principles, and it's often one of the most misunderstood. In order to understand diversification you first have to take a comprehensive view of the process of planning a portfolio.

Investors tend to view individual investments in isolation. This often happens because of the focus we place on finding the best overall investment versus figuring out how individual investments work together for the benefit of the whole.

Instead of looking at investments in isolation, we should consider them part of a much larger tapestry, and make sure that the overall picture reflects intelligent portfolio design concepts backed up by an academic approach.

Diversification's primary power is that it lets us reduce risks that are avoidable.

These avoidable risks include:

- **Betting on a particular industry or sector.** We see this in the form of trying to pick the next hot sector, like technology, banking or oil stocks.

- **Market timing.** Most of us believe that you can't figure out when stocks will zig and bonds will zag. At the same time, we're often quick to latch on to anything that might look like detailed research about the direction of the markets. In reality, it's nothing more than a guess.

- **Owning individual stocks.** While it's certainly not impossible to identify the next Apple, history proves that it's highly improbable. Placing large, concentrated bets on individual stocks can be a path to incredible wealth, but so can a single spin of the roulette wheel (if you get lucky).

The magic of diversification is that you can take two individual investments, which when viewed in isolation are individually risky, and blend them in a portfolio. Doing so creates an investment that's actually less risky than the individual components and often comes with a greater return. In finance, this is as close as we get to a free lunch.

What Diversification Looks Like

Here's what a sample, diversified portfolio might look like.

First, let's start with two, undiversified portfolios. *Portfolio A* is invested 100 percent in United States stocks, as measured by the S&P 500-stock index, and *Portfolio B* is invested 100 percent in international stocks, as measured by the MSCI EAFE index. We'll use 34 years (1976-2010) for our sample period since it's the longest period available for which we have data from MSCI EAFE.

During those 34 years the S&P 500 had an annualized return of 11.17 percent, and international stocks had an annualized return of 10.72 percent. (All of the portfolios mentioned in this post were rebalanced quarterly. And yes, I know that you can't invest in an index per se, but you can buy index funds and similar vehicles for next to nothing.)

Now let's look at the risk associated with each of these hypothetical investments.

Although there are many ways to view risk, for our purposes we'll focus on the number of negative quarters and volatility as measured by standard deviation (the lower this number is, the better). From 1976-2010, the S&P 500 had 42 negative quarters and a standard deviation of 15.39 percent. International stocks had 45 negative quarters with a standard deviation of 17.26 percent.

As you can see, each of these portfolios look risky individually. But the magic of diversification is that when we blend them, the whole is better than the sum of its parts.

So let's create *Portfolio C* using use a fairly standard 60 percent allocation to the S&P 500 and 40 percent allocation to international stocks. Now this portfolio gets a return of 11.21 percent. While that's not much better than the S&P 500 alone, in terms of risk, this 60/40 portfolio only had 37 negative quarters with a standard deviation of 14.45 percent.

That may not sound like much, but it is indeed a free lunch. This portfolio returns at a higher rate with less risk using the simple concept of diversification.

Reducing Risk

When I talk about diversification, I often get told that it's been irrelevant over the last 10 years, particularly during the global credit crisis in 2008-2009.

Sure, you can see the benefits of diversification clearly when you're focused on different types of stocks. But in times of large systematic risks to the stock market (like what we've seen during the last five years), the value of diversification among equity asset classes can often go away.

So while it is still a valuable exercise to carefully plan your equity portfolio to take advantage of a free lunch where you can, the real power of diversification comes in the form of risk reduction when you start to mix stocks and bonds.

Let's compare the 60/40 stock portfolio we built above (Portfolio C) to a portfolio where we add 40 percent in bond exposure.

Remember that Portfolio C generated a return of 11.21 percent with 37 negative quarters and a standard deviation of 14.54 percent. When we blend in a 40 percent allocation to bonds (in the form of the Barclays Capital Aggregate Bond Index), creating Portfolio D, we get a return of 10.4 percent. That's not much lower than the all-stock portfolio, and we reduce the number of negative quarters to 35.

But the real impact is in the risk reduction we see in the form of a much lower volatility as measured by standard deviation at 9.48 percent. In other words, the ups and downs of Portfolio D will be much less sharp than Portfolios A, B, and C.

While I'm not suggesting that this portfolio is right for every individual or serves as a predictive model, the historical data at least show how being diversified can give you a way to protect yourself from many of the random events that have ruined fortunes.

Plus, diversification allows you to position yourself to take advantage of the returns that equities tend to deliver, balanced with the safety that high-quality bonds provide.