Diversification: A Fundamental Strategy for Reducing Portfolio Risk

Diversification is one of the most basic investment concepts. It is used by novice investors and sophisticated portfolio managers alike to help reduce portfolio risk and dampen the negative effects of market volatility.

The premise behind diversification is easy to grasp: When you own a range of investments, you may reduce risk by creating the potential for better performers to compensate for poor performers.

Effective diversification involves more than simply holding a jumble of different investments, though. It means selecting a mix of securities that may not react in the same way to a given set of conditions—in other words, investments that carry a low “correlation” to one another. Correlation is a statistical measure of the degree to which two securities perform the same under particular market conditions.

For instance, if you choose stocks of two companies that make the same product and serve the same market, chances are that they will move in tandem when conditions affecting their industry change. Owning both would be unlikely to lower risk in your portfolio. By contrast, owning stocks of companies that operate in different segments of the economy may help improve your risk-adjusted return, although past performance is no guarantee of future results.

Diversification vs. Asset Allocation—An Important Distinction

First, be sure you have a handle on the concept of asset allocation, which is often confused with diversification. Assume for a moment that you are assembling a portfolio from scratch. Before you select specific investments, you will need to decide what percentage of your money to put into each of the three major asset classes: stocks, bonds and money markets, or cash. That is your asset allocation: spreading your money among asset classes based on your goals, risk tolerance and time horizon.

Once you have determined your target asset allocation, you can then turn to the task of diversifying your portfolio. Within the different asset classes, you can diversify your holdings by investment type or style. For stocks, there are a number of different styles to choose from: growth vs. value, large cap vs. small cap, domestic vs. foreign or by sector or industry group.1

For bonds, there also are many different types to select from. You may choose to diversify by type (government, agency, municipal, corporate), maturity, credit quality or specific bond features, keeping in mind that different bonds react differently to market interest rates and other factors.2

Technically speaking, asset allocation may potentially reduce market risk, while diversification may potentially reduce company-specific risk. And together, they may help reduce portfolio volatility over time. Keep in mind that neither diversification nor asset allocation guarantees against investment losses.

Protection on the Downside

Both asset allocation and diversification are particularly important when a market takes an unexpected downturn. In such a situation, some investments inevitably are more affected than others, but the overall effect of a downturn on a diversified portfolio may potentially be mitigated.

Consider the investor who invested 100% in financial stocks as represented by the total returns of the S&P 500 Financials index during the height of the financial crisis from January 1, 2007, through December 31, 2008. He would have lost approximately 64% of his investment. If the same investor had diversified his holdings to encompass a broader representation of U.S.
stocks that paralleled the S&P 500 index, he would have lost only about 34% over this period. Had he further diversified his portfolio by allocating 20% to cash and 30% to bonds and invested the remainder in a broad mix of domestic stocks, he would have narrowed his losses to about 13%.³

However you choose to diversify your portfolio, remember that diversification works two ways. Although it can cushion the impact of a falling market, it can also dilute returns on the upside. Ultimately, you should balance your degree of diversification with your overall appetite for risk.

¹Securities of smaller companies may be more volatile than those of larger companies. The illiquidity of the small-cap market may adversely affect the value of these investments. Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Sector funds may be more volatile than funds that diversify across many sectors or industries.

²Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value. Municipal bonds are subject to availability and change in price. They are also subject to market and interest rate risk if sold prior to maturity. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax free, but other state and local taxes may apply.

³Source: Standard & Poor’s. Bonds are represented by the total returns of the Barclays U.S. Aggregate index. Cash is represented by the Barclays 3-Month Treasury Bills index. Individuals cannot invest directly in an index. Past performance is no guarantee of future results.