The Wealth Report

The goal of diversification is to spread out invested assets among a wide variety of holdings to reduce the chances of losing money should one investment, asset class or sector drop in value. Not only can diversifying help manage risk, but it also offers opportunity for growth even if other portions of the portfolio decline.

3 REASONS TO DIVERSIFY

Overview

To build a diversified portfolio, it is key to combine investments whose historical returns have not moved in lockstep together. For example, when stocks outperform, different types of bonds may underperform, and vice versa. This strategy helps provide the opportunity for continued growth in some portion of the portfolio with the goal of offsetting declines among other assets. If everything works according to plan, the total portfolio is less likely to suffer significant loss.

Diversification has long been recognized as a risk-management tactic for retirement portfolios. In fact, the Employee Retirement Income Security Act of 1974 mandates that fiduciaries who manage retirement assets diversify plan investments in order to minimize the risk of extensive losses.[1]

Here are three reasons it is a wise idea to have a diversified portfolio:

1. Prudent, Balanced Approach

Diversification helps provide a more balanced approach to investing. Too often, investors seek to chase performance when prices are on the rise and retreat to lower-risk investments during a market downturn. This latter strategy can cause a drain on long-term investment performance for many reasons, such as:

- No one is consistently successful at market timing
- Buying high and selling low
- Trading costs
- Tax liabilities

By diversifying across a mix of both higher and lower-risk securities, portfolio performance is generally more restrained from both the highs and lows of market swings and may provide more consistent returns.

A study conducted by Morningstar revealed that, over time, the average performance of an investor prone to buy and sell based on market conditions tended to trail that of a well-balanced buy-and-hold investor.[2]

"Well-diversified portfolios minimize 'variance drain' which contributes to less risk (less volatility) and more gain."[3]

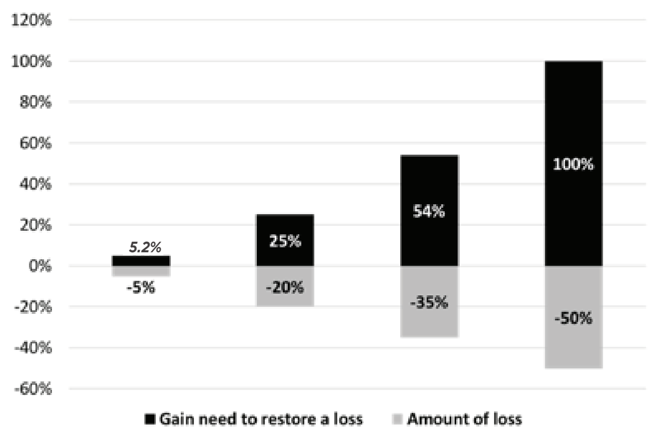
2. Recovery: Pure Math

A second reason to invest in a diversified portfolio is to reduce the recovery time after a market downturn. After all, the worse the losses, the longer it takes a portfolio to recover. This can be illustrated through a simple mathematical calculation.

The accompanying bar chart shows how bigger losses require bigger gains to recover. In contrast, a diversified portfolio is likely to lose less ground and thus need less outperformance or time to rebound. Looking at this strictly from a loss perspective:[4]

- A portfolio that has decreased in value by 5% will have to post a 5.2% gain to recover its original value
- A portfolio that has decreased in value by 20% will have to post a 25% gain to recover
- A portfolio that has decreased in value by 35% needs to achieve a 54% gain to recover
- A portfolio that has decreased in value by 50% needs to achieve a 100% gain to recover

Gains Needed to Recover from a Market Decline[5]



3. How You Reach Your Goals Matters

A third reason advisors frequently recommend diversifying as an investment strategy is that, from a psychological point of view, the pain people feel when losing money is typically more pronounced than the joy they feel with portfolio gains.[6] Even people who are comfortable investing aggressively are bound to be aggrieved by losses. Therefore, diversification is not just an investment strategy; it's a way to help investors control mood swings that may parallel the direction of the markets.

In short, a diversified investor may feel more confident about his or her long-term prospects for meeting financial goals. For some folks, it's not just about meeting their investment objectives — but doing so with less market-induced stress.

Final Thoughts

While spreading out investments across a wide selection of financial products offers the benefits of diversification, recognize that this is not a one-time event. You should monitor the progress of all of your financial assets to help ensure they stay on track to meet your goals. Because market returns often throw a prescribed asset allocation strategy out of whack, you should maintain the careful mix of asset class percentages aligned with your tolerance for risk, and don't be afraid to periodically rebalance your assets (sell outperformers) to retain your strategy.

Also, you will want to assess your diversification strategy across all of your investment accounts (e.g., 401(k), IRA or investment portfolio, etc.) to ensure that many of your holdings do not overlap — which can negate the benefits of diversifying. It is generally a good idea to work with a financial advisor to help you keep track of all of the moving parts in your financial portfolio.

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[1] W. Scott Simon. Morningstar. May 3, 2018. "Why Diversification Pays in Rising Markets, Too." https://www.morningstar.com/articles/863094/why-diversification-pays-in-rising-markets-too.html. Accessed Oct. 2, 2018.
[2] Fidelity. Aug. 1, 2018. "The guide to diversification." https://www.fidelity.com/viewpoints/investing-ideas/guide-to-diversification. Accessed Oct. 2, 2018.
[3] W. Scott Simon. Morningstar. May 3, 2018. "Why Diversification Pays in Rising Markets, Too." https://www.morningstar.com/articles/863094/why-diversification-pays-in-rising-markets-too.html. Accessed Oct. 2, 2018.
[4] Ibid.
[5] Ibid.
[6] Ibid.

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