THE Wealth REPORT

Investment diversification is often correlated with the adage, "Don't put all your eggs in one basket." But how stable is it to carry a bunch of small baskets out to the chicken shed, fill each with an egg or two and then haul them all back to the house? The message here is that there are traps some investors fall into when they diversify. The key is to manage all investments as one portfolio — flexible enough for a bit of jostle and easy enough to manage.

DIVERSIFICATIONS DO'S AND DON'TS

Overview

Diversification is the tactic of spreading invested money across a range of different holdings in an effort to avoid losses from one poorly performing investment. However, the point is not to invest in a wide range of securities that may not fit your profile just for the sake of dispersing wealth.

The point of diversifying is to manage risk. When money is spread out among investments, chances are good that, in most market environments, some aspect of the portfolio will continue to grow even when other investments experience a decline.

However, past research has shown that holding too many securities can increase investor cost without delivering better returns or reducing portfolio risk. One study found that the diversification benefit is maximized when an investment holds no more than 20 to 30 different securities.[1]

Despite this finding, thousands of mutual funds hold upwards of 100 or more securities. On top of that, many investors hold multiple mutual funds for diversification purposes. Some even add exchange-traded funds (ETFs) — another collection of securities — to the mix, as well as a variety of holdings in their 401(k) plan at work. Therefore, it's not uncommon for investors to own literally hundreds of securities, with some of the same ones in different funds.

That's like carrying dozens of baskets of eggs back to the farmhouse. When you consider diversification from this perspective, it is easy to see where investors could be doing more harm than good to their portfolio.

Perils of Over-Diversification...

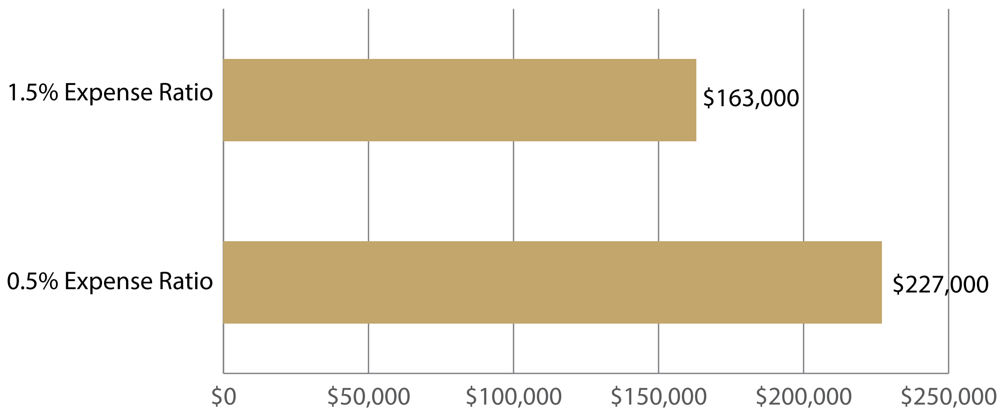
"You should track individual parts of your portfolio to ensure you are not duplicating your investments without any benefits of diversification."[2]

Higher Investment Fees

On the surface, it might appear that there's no real harm in over-diversifying. However, there can be when you consider the combination of fees an investor pays. Mutual funds may charge a combination of sales, administrative, management, and marketing and distribution (12b-1) fees.

Consider the impact of high fees on a portfolio that starts out with $25,000 and earns an average 7 percent annual return over 35 years. The difference between 0.5 percent and 1.5 percent would result in 28 percent less return.[3]

IMPACT OF RETURN BASED ON EXPENSE RATIO OVER 35 YEARS



The lesson here is that the more an investor diversifies, the more he or she may be paying in fees that could hurt long-term performance.

Lackluster Performance

Speaking of performance, does diversifying mean you're more likely to earn higher returns? In a word: No. Diversification is largely a risk-management strategy, designed to protect an investor from investing too much of his or her wealth in a poor performing investment. By spreading assets over different types of investments, typically ones that do not move in lockstep with each other, the investor spreads out his or her risk of loss. The idea is that some investments should be performing well even when others drop.

Be aware that the same risk-management theory applies to ascending markets. The more diversified a portfolio, the less likely all securities experience market highs at the same time. Not only is the risk diversified; so are the rewards. That's another cost of over-diversifying.

Risk Potential

And finally, how well does diversification protect an investor from risk of loss? When you look back at diversified portfolios during the 2008-2009 crash, not much. That was a market period when all types of investments tanked. In other words, at a time when investors most needed a risk-management strategy, diversification wasn't one that could deliver.[4]

Advantages

With all of that said, understand that diversification is a sound investment strategy. But like all good ideas, it requires proper implementation. When working correctly, a diversified portfolio features ongoing growth even when some holdings are declining. It provides balance — the same type of stability required to carry a bunch of eggs in one basket.

Think of the basket as your portfolio. It would be foolish to carry 100 eggs in one basket. However, a handful of different types of eggs — chicken, duck, bantam and quail — might provide the level of diversification needed for risk management without suffering the negative effects of high costs and beleaguered performance.

Consider these tips for diversification:

- Avoid owning hundreds of different securities over multiple investment vehicles.
- Seek a variety of assets with returns that tend to move in opposite directions, such as:
  - Diversifying across different sectors
  - Diversifying globally, including U.S. companies with significant overseas interests
  - Diversifying among varying maturities, credit qualities and durations of bonds
  - Diversifying across small, mid and large capitalization companies
  - Diversifying across investment strategies (e.g., growth and value)
- Review investment fees whenever you receive quarterly or annual statements.
- Seek low-cost investments (many of which hold the same securities as high-cost ones).
- Consider various financial vehicles, such as REITs, bond ladders and annuities.
- Pay attention to individual holdings — buy what you believe in.

Rebalancing

One more thing to keep in mind about diversification: It's not a one-time task. Our financial needs and objectives change over time, as does our time frame. The closer you get to a financial goal, such as paying out college tuition or retirement income, the more you may wish to transition assets to more conservative holdings to reduce risk of loss.

Also consider that the markets can change your diversification mix. Outperformance in one area can cause a portfolio to be too heavily weighted in a particular sector or asset class. Once you determine a target mix, it's important to monitor performance on a regular basis and rebalance as necessary. Periodic rebalancing (selling outperformers and reinvesting to retain your strategic allocation) aligns your portfolio with a risk level consistent with your goals and investment timeline.

Final Thoughts

Diversification is generally considered a simple investment concept, but it's clearly not. You want to diversify among asset classes, but they need to be strategically aligned to your goals and investment horizon. You want to implement a risk-management strategy, but you don't want to be so over-diversified that it impinges upon your portfolio's returns. You want each account in your portfolio — IRA, 401(k), mutual funds — to be appropriately diversified, but you don't want a lot of overlap in holdings. And finally, you need to monitor for changes skewed by performance and actively rebalance when they no longer align with your investment profile.

Even the simplest investment concept can be complex, so it's generally a good idea to work with a financial advisor who can help you keep track of all of these moving parts.

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[1] 1 Kenneth G. Winans. Forbes. "5 Big Mistakes Investors Make When They Diversify." Feb. 5, 2015. https://www.forbes.com/sites/janetnovack/2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#735ebac2395d. Accessed July 26, 2017.
[2] Sunita Abraham. Livemint. July 26, 2017. "Does your portfolio suffer from a problem of plenty?" http://www.livemint.com/Money/ycbrSAE6VhvBRMTIBwuP1N/Does-your-portfolio-suffer-from-a-problem-of-plenty.html. Accessed July 26, 2017.
[3] Andrew Osterland. CNBC. April 6, 2017. "What you don't know about 401(k) fees can cost you plenty." http://www.cnbc.com/2017/04/06/what-you-dont-know-about-401k-fees-can-cost-you-plenty.html. Accessed July 26, 2017.
[4] Kenneth G. Winans. Forbes. "5 Big Mistakes Investors Make When They Diversify." Feb. 5, 2015. https://www.forbes.com/sites/janetnovack/2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#735ebac2395d. Accessed July 26, 2017.

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