LEHMAN & LEAVY
WEALTH MANAGEMENT

THE IMPORTANCE OF DIVERSIFICATION

Personal Investing Series

Article 4

The adage goes in real estate there are just three important things to consider - location, location, and location. I think that there should be a similar adage for investing. It is diversification, diversification, and diversification.

Diversification is not just making additional investments; it is making investments that are meaningfully different from ones you already have. For instance, it is not good enough to invest in a mutual fund consisting of lots of large US stocks. Certainly this is better than investing in just a few large US stocks. But they are still a bunch of large US stocks that are all going to perform largely as a function of the US economy. If the US economy takes a dive, so will your portfolio.

Why not also invest in some small US stocks, maybe some European stocks, or Asian stocks, or even some emerging market stocks? Then when the US economy tanks, perhaps some of your other investments will stay flat or even go up. This cuts both ways, of course, in the late 1990s large US stocks was the place to be. If you were diversified, your overall portfolio return would not have been so rosy. However in the early 2000s, international stocks did much better than US stocks. Rmember from earlier articles in this Personal Investing Series, nobody can consistently predict the future, and so you cannot know in advance which market is going to be hot. What you can know is that some market somewhere is going to be hot and that some other market is going to be a dog. So if you are diversified among those markets, you will always participate modestly in both the glory and the pain. If you are in only one market, I can guarantee that someday the pain will be overwhelming. When the pain is overwhelming, the human response is to stop the pain and go to all cash. And if you suffer from a persecution complex, as do many investors, it will be just about then when the market undergoes a spectacular recovery.

Perhaps you don't appreciate this, but it hasn't always been possible for the average investor to diversity so well. Over the last several years mutual fund companies have created well diversified and cost effective specialty funds just for this purpose.

Just how much can diversification reduce risk? Let's suppose you have a single investment in a stock mutual fund. Let's say the expected return is about 10% and it has a risk of 15%. Risk, in this case, is a measure of how much the investment tends to go up and down, or how volatile it is. This kind of risk / reward characteristic is roughly equivalent to a large US stock portfolio. Now in order to diversify our risk; let's say we are going to split our investment between two funds that have the same expected return of 10% and 15% risk. Even though the expected returns for these two investments is an identical 10%, we have selected two investments that are completely independent of each other and therefore their month to month returns are completely unrelated. (In statistics speak, that is known as having zero correlation. If they moved in lockstep with each other, they would have a correlation of 1, and if they moved exactly opposite of each other, the correlation would be -1.)

With our combined portfolio, the expected return is still 10%, but the risk measurement declines from 15% to 10.6%. This is because when one investment is down, the other might be down also, but could also be flat or up. And when one investment is up, the other might also be up, but could be flat or down. What the combination of two investments that are "uncorrelated" does is smooth out the peaks and valleys. We give up nothing in terms of expected return, but we have only about 70% of the risk we used to have. THIS IS AS CLOSE AS TO A FREE LUNCH AS YOU WILL EVER GET WHEN IT COMES TO INVESTING!

In practical terms, finding investments that have a zero correlation is rare, so our example has overstated the potential benefit. However if we modify our example to include 5 different investments, each with the same 10% expected return and 15% risk, and if we assume a more realistic .50 correlation, the combined risk would be about 11.6%. To get that same 11.6% level of risk using just a portion of your original investment and some risk free cash, your return would not be 10%, it would be about 8.9%. That 1.1% difference of return on an investment of $10,000 over 20 years would cost you about $12,250 before taxes.

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