Diversification

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The old chicken farmer lived up on a hill, alone but for the company of his dog. At the end of each day he would go into the henhouse, gather the eggs, and load them into a basket to bring them to market in the morning. He was awakened one night by a commotion – the dog barking and growling, the hens screeching. When he made his way out to the henhouse to investigate, his fears were realized. As quick as his dog was to respond, the fox was quicker. The eggs meant to supply the village had been stolen or destroyed.

The old farmer learned a lesson that day, one I'm sure you've heard of before. Putting an investment portfolio together can seem intimidating, especially for new investors. There are so many principles to learn, ideas to understand, and ultimately decisions to make. One concept within investing that is almost universally understood is diversification. Simply speaking: don't put all your eggs in one basket.

What is Diversification?

In investing, diversification is the act of investing in a variety of different assets. Diversification aims to reduce the overall risk of an investment portfolio without diminishing the return potential. By spreading capital out into an assortment of different types of investments, the impact of a decrease in value to the portfolio in the event one investment suffers losses can be dampened.

Harry Markowitz, the economist, and father of modern portfolio theory, famously called diversification "the only free lunch in finance" due to the potential benefit it can bring to minimize overall risk in a portfolio.

Despite this, many investors still unknowingly have overconcentration issues within their portfolios. One classic example is in real estate; it is not uncommon for someone to gather all their life savings and put it towards purchasing a home. Should something happen to the structure or property, the investor could suffer steep losses.

Risk can be categorized into two categories: systematic and unsystematic risk. While no amount of diversification can reduce systematic risk; risk inherent to the entire market such as inflation, fluctuation in interest rates, economic recession, or any sudden natural disaster. Here are some ways to diversify an investment portfolio to reduce unsystematic risk; risk unique to a specific security, company, or industry.

Diversify: Market Sectors

Consider an investment portfolio containing, among other things, fifteen individual stocks. If one of the individual stock companies should falter, the value of the portfolio would decrease but likely not catastrophically, an example of how diversification can work. However there are more steps that can be taken to reduce risk than simply having more securities. If all fifteen stocks are in the oil industry, a change in legislation or advancement in alternative energy could impact the entire portfolio. Spreading out capital across the 11 GICS (Global Industry Classification Standard) market sectors, can reduce the impact market events that effect entire industries have on a portfolio.

THE 11 GICS SECTORS

1. Energy
2. Materials
3. Industrials
4. Health Care
5. Financials
6. Utilities
7. Consumer Staples
8. Consumer Discretionary
9. Information Technology

10 Communication Services

11. Real Estate

Diversify: Geographies

Just as entire industries can be affected by major events, so can entire countries. Consider again a portfolio containing fifteen securities spread across the 11 GICS market sectors. We are well positioned to survive an event affecting one of the companies or even a market event impacting an entire sector. If, however, all fifteen stocks in the portfolio are companies located in China, the portfolio is still exposed to the risk that geopolitical events could drag down the entire portfolio. For example, new tariffs introduced by the United States could negatively impact all Chinese companies and could greatly damage the portfolio value.

Diversify: Types of Securities

The above examples discuss a diversified equity portfolio, but it is just that: an equity portfolio. To diversify further, consider adding different types of securities into the mix. A truly diversified portfolio would not only contain stocks from varying sectors and geographies but additional asset classes apart from equity. Even with a mix of stocks from around the world, the portfolio is far from immune to the risk of losing money in stocks as global equity markets are becoming increasingly interconnected. Adding assets outside of equities or even outside public markets, may help reduce the impact major market-wide events could have on the portfolio. Of course, these other types of securities each come with risks of their own which should be considered when designing a portfolio.

EXAMPLES OF SECURITIES

- Equities
- Bonds
- Cash
- Commodities
- Alternatives
- Foreign Currencies

Diversifying a portfolio will not remove all the different kinds of risks and does not guarantee a return. There will never be a way to bring the risk in a portfolio down to zero. However by diversifying over market sectors, geographies and types of securities you may be able to mitigate some risk and better positioned for whatever the market may throw your way.

To learn more, please contact your financial professional.