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Effective Investment Diversification Is Not As Simple As Most Think

by Bruce McCain, Chief Investment Strategist, Key Private Bank

We have long been told that diversification eliminates unnecessary risk from our portfolios, but how many investors know how diversification works or how to do it effectively? Is it simply enough to distribute assets across a range of investments, or is the process more complicated than that? Diversification, when it is done well, does have some complexities, so a better understanding of the tradeoffs and pitfalls can be helpful in diversifying more effectively.

Many investors think of diversification simply as insurance against large portfolio losses. That is true to a point, but it is probably better to think of diversification as a process aimed more at improving the predictability of investment returns. Imagine a bell-shaped curve mapping the range of investment returns for specific portfolio strategies. Diversification helps to improve the chances that investment returns will land closer to the center of that curve, or the average. By squeezing the extremes of the investment risk out of the portfolio we help prevent large losses, which most of us consider a positive outcome.

Investors need to realize, however, that diversification also usually limits opportunities for large portfolio gains as it restricts the chances for losses. Even though most of us are willing to give up large gains to avoid large losses, we need to realize that tradeoff is there.

The process of diversification matches investments that compensate for price declines in each other. Some use the analogy of a teeter-totter, where one side rises whenever the other falls. A closer analogy might be to consider going from a two-cylinder engine to an eight-cylinder engine. The coordination of firing across the eight cylinders generates far less vibration – or when it comes to investing, portfolio volatility – than a two-cylinder engine produces. Investment diversifiers provide unique patterns of rising and falling prices that remove price volatility for the portfolio as a whole. In the real world, asset price offsets are typically far from perfect, but the more unique the patterns are, the more potential they have to diversify a portfolio.

For example, U.S. Treasury bonds tend to have modest negative correlations with the S&P 500, meaning when one goes up, the other often goes down. Especially when investors become frightened about equities and rush to sell, they often buy bonds as a safer holding. The tendency for bonds to rise in value when equity prices are plunging makes them a particularly attractive alternative for diversifying equity exposure. But even investments whose prices move much more closely together can still provide diversifying benefits as long as those prices do not move in perfect unison. International equities have a very strong positive correlation with the S&P 500, but there is still enough difference in the price movements to provide some benefits from diversification.

Concluding that assets have unique price patterns, however, does not tell the whole story. We also should consider what specific diversifiers will do to the expected return.

While there are some instances in which diversification will both reduce risk and increase returns, in most instances there is a tradeoff between the two. Ideally, diversification strategies should consider not only an asset's potential to reduce price volatility but also the impact it will have on the expected return of the portfolio.

Bear in mind that some diversification strategies may not be effective at limiting portfolio volatility during exceptionally unpredictable times in the financial markets. Investment professionals often talk about the way that asset prices move in unison when a crisis drives all equity prices lower. We cannot rely on the way asset prices behave during normal times to formulate diversification strategies for periods of market crisis. When investors panic, money tends to flow to the safest assets. Equity money usually flows to bonds and international money typically flows to safer countries like the United States. To identify investments that can provide diversification during a market crisis, we should consider whether the uniqueness in price movements also holds during crisis periods.

While diversification may seem simple, there are complexities to identifying the best diversifiers for specific portfolios and market conditions. Both the potential and the limitations of diversification should be considered in light of our investment goals. Diversification is not necessarily a process where one size neatly fits all. Armed with a better understanding of the process, however, we can often use it more effectively to provide an improved balance of risk and return.

About Bruce McCain

Bruce McCain is the Chief Investment Strategist for Key Private Bank, where he monitors the economy and the financial markets and serves as part of the team that formulates investment strategies for clients. He supplies frequent insights to media throughout the region and around the country. His comments and interviews have been featured in such publications as *The New York Times, The Wall Street Journal, Investor's Business Daily,* and *Business Week,* as well as on television outlets such as CNBC and Bloomberg TV. He is also a regular source for wire services such as the Associated Press and Reuters and is a Contributor on Forbes.com. Bruce joined a predecessor of Key in 1987, after spending six years on the business faculty of the University of Iowa's Henry B. Tippie College of Business. Bruce earned a PhD in Business Administration from the University of California at Berkeley, and undergraduate degrees in Psychology and Accounting from Boise State University.

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