Key Conversations

Why Diversification Matters

A properly diversified portfolio helps you reach your financial goals by spreading your investments over a number of asset categories to avoid excessive exposure to risk. But when it comes to investing, people often make the mistake of thinking that "lower risk" portfolios are safer. While investing more money in bonds and less in equities does reduce some portfolio risk, it may make it harder for you to reach your goals in a timely manner.

A perfect balance is rare in the financial world, but diversified portfolios aim to coordinate investments that fluctuate in value at different times. Consequently, a properly diversified portfolio can more safely employ a larger proportion of "risky" investments that should provide faster portfolio appreciation than the traditionally "safe" investments that deliver lower but relatively predictable returns. Over the next 20 to 30 years, inflation may drive the cost of living substantially higher. That risk makes it particularly important that investors consider taking another look at how well their portfolio is performing and whether it is on track to help them reach their goals.

Balancing risk and safety

If it were possible to predict accurately when a specific investment would decline in value, we could eliminate it from the portfolio. But the science of investing is not that precise. Among other things, diversifying money across a range of investments helps protect our portfolios from events we cannot foresee.

A random mix of high-performing individual investments may sound like a successful investment strategy, but it won't necessarily provide a well-diversified portfolio. Investing for the long term is not simply about owning the "hottest" stocks, but rather creating a balanced portfolio that performs steadily.

Surviving market highs and lows

As investors, we sometimes fear equities most when the economy is in recession and stock prices are plummeting, believing we should sell those particular holdings (e.g., overseas investments) that have recently underperformed. Yet those investments often offer the best opportunities.

It is often extremely difficult to predict the course of the economy and corporate earnings accurately, much less the way that investors will respond to the economy or earnings. The best chance of success comes when investors target appropriate average allocation exposures in their portfolios and then adjust the portfolio periodically so that the minimum and maximum exposures stay reasonably close to those averages.

Key Takeaways

Longer life expectancies should be taken into consideration for long-term planning, and investors need to have enough equities in a diversified portfolio to meet their future needs.

Money invested in equities over the long term should earn better returns when it remains invested through market highs and lows that occur over time.

New investment options and a host of new ways to invest in the traditional mix of equities, bonds, and cash can also help to reduce portfolio risk.

Most investors gravitate towards large U.S. corporations that they know and trust. The science of diversification tells us, however, that we can more safely achieve higher portfolio returns if we also invest in smaller U.S. equities, overseas equities or alternative assets whose values do not vary as closely with equities and fixed income investments. New investments and new ways of investing in the traditional mix of equities, bonds and cash provide additional options for achieving better returns with more controlled risk.

Time is on your side

Many investors don't realize that time helps "diversify" the risk of investing. On average, equity prices have risen about three years out of four, and over the long term the risks of loss are significantly reduced. Equities may decline in value if money is needed within a relatively short period of time (less than five years, generally speaking). But investors have rarely lost money in equities over a 15-year horizon, and equities have historically returned significantly more than bonds or cash over a 30-year time period. By remaining invested through the market highs and lows that occur over time, long-term investors can capitalize on the higher returns of equity investments with reasonably modest levels of risk.

While a long-term strategy is particularly appropriate for young investors, most people today can expect to live at least 30 years in retirement and longer life expectancies should be taken into consideration for long-term financial planning. This is another reason investors should consider including more equities in a diversified and long-term portfolio.

Should investors always have a high exposure to equities in their portfolios? Certainly not. There are times when conditions in the economy and markets are more volatile and portfolio risk can profitably be reduced. Modest reductions of exposure can limit the damage of adverse conditions, but investors should keep most of their equity exposure in place by using properly diversified holdings.

Conclusion

Diversification is an important tool for creating a portfolio that has a better balance of risk and return for each investor. A solid financial plan combined with disciplined portfolio diversification helps to maximize the odds that investors will reach their financial goals.

If you want to learn more about portfolio diversification, contact your Key Private Bank Relationship Manager.

Investment products are:

NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE • NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

Information provided is not intended to be individual investment advice. KeyBank does not give legal advice. Since laws are always subject to interpretation and possible changes, KeyBank strongly recommends that you seek the counsel of an attorney and/or other qualified tax advisor as to the specific legal and tax consequences of all planning concepts as they apply to the facts of your particular situation.

© 2016 KeyCorp. 161117-164245