





INVESTING > PORTFOLIO MANAGEMENT

Diversification

By TROY SEGAL | Updated Oct 7, 2019

What Is Diversification?

Diversification is a <u>risk management</u> strategy that mixes a wide variety of investments within a portfolio. A diversified portfolio contains a mix of distinct asset types and investment vehicles in an attempt at limiting exposure to any single asset or risk. The rationale behind this technique is that a portfolio constructed of different kinds of assets will, on average, yield higher long-term returns and lower the risk of any individual holding or security.









The Basics of Diversification

Diversification strives to smooth out unsystematic risk events in a portfolio, so the positive performance of some investments neutralizes the <u>negative performance</u> of others. The benefits of diversification hold only if the securities in the portfolio are not perfectly <u>correlated</u>—that is, they respond differently, often in opposing ways, to market influences.









securities generates further diversification benefits, albeit at a drastically smaller rate.

KEY TAKEAWAYS

- Diversification is a strategy that mixes a <u>wide variety</u> of investments within a portfolio.
- Portfolio holdings can be diversified across asset classes and within classes, and also geographically—by investing in both domestic and foreign markets.
- Diversification limits portfolio risk but can also mitigate performance, at least in the short term.

Diversification by Asset Class

Fund managers and investors often diversify their investments across asset classes and determine what percentages of the portfolio to allocate to each. Classes can include:

- Stocks—shares or equity in a publicly traded company
- Bonds—government and corporate fixed-income debt instruments
- Real estate—land, buildings, natural resources, agriculture, livestock, and water and mineral deposits
- Exchange-traded funds (ETFs)—a marketable basket of securities that follow an index, commodity, or sector

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different <u>market capitalizations</u>. In the case of bonds, investors can select from investment-grade corporate bonds, U.S. Treasuries, state and municipal bonds, high-yield bonds and others.

Foreign Diversification

Investors can reap further diversification benefits by investing in foreign securities because they tend to be less closely correlated with domestic ones. For example, forces depressing the U.S. economy may not affect Japan's economy in the same way. Therefore, holding Japanese stocks gives an investor a small cushion of protection against losses during an American economic downturn.

Diversification and the Retail Investor

Time and budget constraints can make it difficult for noninstitutional investors—i.e., individuals—to create an adequately diversified portfolio. This challenge is a key reason why <u>mutual funds</u> are so popular with retail investors. Buying shares in a mutual fund offers an inexpensive way to diversify investments.

While mutual funds provide diversification across various asset classes, exchange-traded funds (ETFs) afford investor access to narrow markets such as commodities and international plays that would ordinarily be difficult to access. An individual with a \$100,000 portfolio can spread the investment among ETFs with no overlap.

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spreading-out strategy works both ways, lessening both the risk and the reward.

Say you've invested \$120,000 equally among six stocks, and one stock doubles in value. Your original \$20,000 stake is now worth \$40,000. You've made a lot, sure, but not as much as if your entire \$120,000 had been invested in that one company. By protecting you on the downside, diversification limits you on the upside—at least, in the short term. Over the long term, diversified portfolios do tend to post higher returns (see example below).



Pros

- Reduces portfolio risk
- Hedges against market volatility
- Offers higher returns long-term

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- Limits gains short-term
- Time-consuming to manage
- Incurs more transaction fees, commissions

Diversification and Smart Beta

Smart beta strategies offer diversification by tracking underlying indices but do not necessarily weigh stocks according to their market cap. ETF managers further screen equity issues on fundamentals and rebalance portfolios according to objective analysis and not just company size. While smart beta portfolios are unmanaged, the primary goal becomes outperformance of the index itself.

For example, as of March 2019, the iShares Edge MSCI USA Quality Factor ETF holds 125 largeand mid-cap U.S. stocks. By focusing on return on equity (ROE), debt-to-equity (D/E) ratio, and not solely market cap, the ETF has returned 90.49% cumulatively since its inception in July 2013. A similar investment in the S&P 500 Index grew by 66.33%.

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With this mix of ETF shares, due to the specific qualities of the targeted asset classes and the transparency of the holdings, the investor ensures true diversification in their holdings. Also, with different correlations, or responses to outside forces, among the securities, they can slightly lessen their risk exposure. (For related reading, see "The Importance Of Diversification")

Related Terms

International ETF Definition

An international exchange traded fund (ETF) is any ETF that invests in foreign-based securities. more

Fund Overlap

Fund overlap is a situation where an investor invests in several mutual funds with overlapping positions. more

Mutual Fund Definition

A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities, which is overseen by a professional money manager. <u>more</u>

Risk

Risk takes on many forms but is broadly categorized as the chance an outcome or investment's actual return will differ from the expected outcome or return. <u>more</u>

Portfolio Management Definition

Portfolio Management involves deciding investment mix and policy, matching investments to goals, asset allocation and balancing risk with performance. <u>more</u>

Smart Beta

Smart beta investing combines the benefits of passive investing and the advantages of active investing strategies. <u>more</u>

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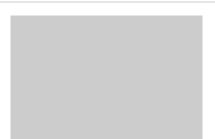
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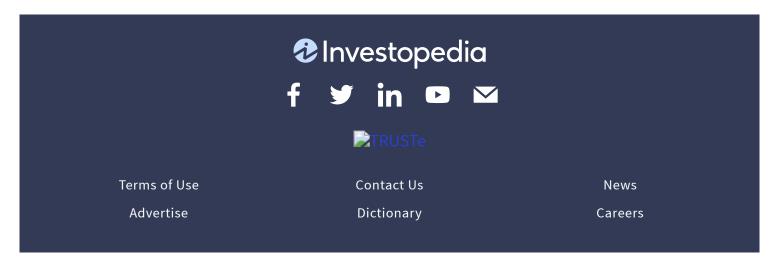






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The Many Ways to Achieve Investment Portfolio Diversification



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