Guide to Diversification

Description

A common maxim new investors hear is to “not put all your eggs in one basket.” This is easy to understand. After all, the risks of buying just a single stock are much greater than owning two, three, or a few dozen. Intuitively, investors know that betting their entire portfolio on a single company isn’t the safest investment approach.

This understanding is central to the concept of diversification, an important factor in ensuring the best risk-return relationship for investment choices. Let’s break down what it is and how you can accomplish it.

What is diversification?

When it comes to investing, diversification means selecting and allocating the different assets in a portfolio to reduce different types of risk.

When investors create a portfolio, they usually do so with certain return expectations in mind (e.g., return an annualized 7% per year on average). To do so, they may select different assets that provide returns in exchange for risks, such as:

1. Stocks
2. Bonds
3. Cash
4. Alternatives

The important thing to note is that each asset class has different correlations to each other. That is, when one zigs, the other can zag. Assets with low or negative correlations with one another are especially beneficial for diversification.

For instance, bonds (especially government ones) can rally during a crash when stocks fall. An investor with a diversified portfolio holds many different assets with varying correlations to each other, thus offsetting their types of risk.

Why is portfolio diversification important?

The main benefit of diversification is better risk-adjusted returns. This is commonly measured by the Sharpe ratio, which describes how many units of return an investment security or portfolio provides versus how many units of risk it takes on. A diversified stock index, for example, would have a Sharpe ratio close to 1 such as that of the **Toronto Stock Exchange (TSX)** or **S&P 500** indexes at 0.60% and 0.72%, respectively. Fast-growing air freight company Cargojet, on the other hand, has a Sharpe ratio of 1.7, so you would receive 1.7 % in returns for every dollar you invest.

Diversification helps investors earn proportionately more return while taking on proportionately less risk. A properly diversified investment portfolio can either:

1. Help investors take on the same risk as a non-diversified one, but with a higher return; or
2. Help investors take on less risk as a non-diversified one, but with the same return.

How does diversification reduce risk?

Proper diversification reduces risk by ensuring that no single asset in your investment portfolio can overtly influence its performance.

For example, if stocks fall, a diversified portfolio will have bonds that pick up the slack. If stocks and bonds both fall, alternatives like commodities and gold can soar. If all fall in a very bad crash, cash can keep some value in the green. Diversification ensures layers of protection so a bad spell of performance for a single asset doesn’t compromise the entire portfolio.

The takeaway here is that each asset class has its own risks. By spreading out your portfolio across many assets that don’t always move in the same direction, you can reduce your exposure to different sources of risk for a smoother sequence of returns.

Diversification also reduces tail risk, which is the small, remote chance of a very bad loss wiping out your portfolio. Examples like a stock going bankrupt, a country defaulting on its bonds, or commodities going negative will affect you less when you have other assets to offset any losses.

How to diversify your investments

Diversifying your investments starts with answering some questions about your investment objectives. These questions will determine the degree of diversification you might require, and which assets should be held to achieve that.

1. **Risk tolerance:** How much fluctuation or loss are you able to tolerate in your portfolio without

panic selling or changing your strategy?
2. **Time horizon**: How long will it be before you need to start withdrawing money from your portfolio?

Diversifying with stocks

Holding a single stock is non-diversified and highly risky. The main risk here is idiosyncratic risk, or the risk that a company undergoes a catastrophic negative event such as bankruptcy, fraud, declining sales, or delisting. The chances of this are mitigated the more stocks you hold, so the first step is to hold more than a single stock.

The next risk is sector risk. For example, holding 100% of your stocks in energy companies exposes you to the risks of that industry, in this case falling commodity prices or environmental regulations. To mitigate this concentrated exposure, consider holding stocks from all 11 stock market sectors without excessively overweighting one.

The next risk is market capitalization risk. Stocks come in all shapes and sizes, from mega-, large-, mid-, small-, and micro-caps. Different market caps have different risks.

For instance, small- and micro-cap stocks tend to be highly volatile. To mitigate this, consider choosing stocks by their market cap weight, which means a higher proportion of mega-cap and large-cap stocks, followed by a proportionately smaller holding in mid-, small-, and micro-caps.

Finally, investors should diversify away from geographical risk. This is the risk of only investing in a single country or region's stock market. For example, while the U.S. market is a strong performer, it was outperformed by the rest of the world from 2002–2009, known as the “lost decade”. To mitigate this, consider holding stocks from countries in the same proportion that they represent in the world. For example, the U.S. stock market comprises around 55% of the world, so a diversified portfolio might also hold a 55% weighting.

Diversifying with bonds

As fixed-income securities, bonds serve two purposes in a portfolio. Firstly, they reduce volatility, which is how much your portfolio fluctuates up and down. Second, they reduce drawdowns, or the peak-to-bottom losses your portfolio experiences during a crash.

Bonds are not risk-free. Changes in interest rates can negatively or positively affect bonds as bond prices are inversely related to interest rate changes. Bond convexity also means that longer-duration bonds are more sensitive to interest rate changes. Generally, investors should hold a “ladder” of bonds with a duration matching their time horizon. For example, an investor with 10 years until retirement may choose to hold bonds expiring in 10 years.

The type of bond matters, too. Generally, investors want investment grade (A, AA, or AAA) corporate and government bonds. Corporate bonds have a higher yield, which is great for income, but tend to fall during market crashes as they are risiker. Government bonds like U.S. Treasurys and Canadian Federal and provincial government bonds have a very low default risk but tend to have lower yields. Generally, an even mix of investment grade government and corporate bonds is considered diversified.

Diversifying with cash and alternatives

Cash is a risk-free asset; in that it will not lose value during a crash. However, it is easily eroded by inflation. Still, investors with a lower risk tolerance or time horizon can consider a cash allocation for when stocks and bonds fall together. Good ways to hold cash include guaranteed investment certificates (GICs), high-interest savings accounts (HISAs), and money-market instruments.

Alternatives such as commodities, precious metals, and real estate are useful diversifiers because they have a low correlation with stocks and/or bonds. This can help keep your portfolio in the green when stocks and bonds fall in tandem, like during 2022 when inflation and interest rates rose. However, too high of an allocation to alternatives can be risky, given their high volatility.

How to measure portfolio diversification

Investors can measure their portfolio's level of diversification by comparing its historical performance to an undiversified benchmark, such as the S&P 500 index. Metrics to pay attention to include:

1. **Volatility:** How much the portfolio fluctuates around its average return.
2. **Drawdowns:** How much a portfolio lost in value historically from a high peak to a low trough during a bad crash.
3. **Sharpe ratio:** How much return the portfolio has earned historically versus how much risk it took on (with a higher Sharpe ratio being better).

A good example of a diversified, growth-oriented portfolio might be the following:

- 70% in global stocks from all market sectors, weighted towards large-caps with mid- and small-caps contained in smaller proportions.
- 20% in investment-grade government and corporate bonds with an intermediate duration.
- 5% in alternatives like a broad basket of commodities.
- 5% in cash and money market instruments.

How much diversification is too much?

Diversification improves risk-adjusted returns but will lower total returns past a certain point. A 100% stock portfolio may be inefficient compared to a 60/40 stock/bond portfolio in that it takes on more risk for its return, but over long periods of time, will ultimately return more. The investor in the 60/40 portfolio will however have a much smoother ride and consistent sequence of returns.

Younger investors with a high-risk tolerance may want to consider lowering their level of diversification if they have aggressive growth objectives in mind for their portfolios. For example, a large (40%) allocation to bonds, alternatives, or cash may be detrimental to young investors who have a long time until retirement and are aiming to grow a large portfolio. In this case, allocating more towards stocks and taking on more investment risk might be appropriate.

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