What is investment portfolio diversification?

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Published by The Skilled Investor on Jul/10/2005

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From the perspective of holding a well-diversified investment portfolio according to scientific investment principles, the objective of diversification is to minimize or eliminate ‘unsystematic risk’ or those risks that are not related to the price volatility of the overall securities markets. When people speak of investment diversification, they may mean different things. Therefore, at the outset clear definitions are important. Unsystematic risk is the risk that relates to company-specific risk factors, such as new or increased competition, labor strikes, faulty management decisions, adverse technological changes, etc. By holding a very broadly diversified portfolio containing the securities of numerous companies in different economic spheres, the risk in your portfolio can be dramatically reduced. By holding the full market in your portfolio through broad-based index funds, unsystematic risk can be fully eliminated. Unsystematic risk can be eliminated, because there is not a one-to-one correlation between the opportunities and risk factors that affect each particular firm. To the extent that you hold more than one firm in your portfolio and particularly a very large number of them, then company specific price movements tend to cancel out the securities price fluctuations of other firms. When fully diversified, securities market risk measured by its market price volatility will remain. When you hold the entire market as your investment portfolio, then you achieve a very significant reduction in the price volatility of your overall personal investment portfolio. What remains then is only the ‘systematic risk’, or the impact of broader economic, policy, and political risk factors, such as general changes in economic growth, monetary policy, inflation, taxation, wars, exchange rate fluctuations, etc. A well-diversified portfolio is still subject to these systematic risks. In summary, you diversify to eliminate the company specific risks to your investment portfolio. You also do this, because the market does not compensate you for company specific risk. Equity risk premiums are paid to investors, because they are willing to expose themselves to market risks and not to company specific risk. Sometimes investors believe that diversification means holding a hodge-podge of mutual funds or exchange-traded funds with different styles such as growth, value, small cap, balanced, international, emerging markets, etc. While holding multiple mutual funds of differing styles can contribute significantly to diversification in the investment science sense, the real question is whether this is the most efficient approach after investment costs and taxation are taken into account. Instead, the overall market portfolio is the fully diversified benchmark of investment science, which fully eliminates unsystematic securities investment risk. The full market portfolio is global and includes all investment styles.Holding broad market indexes through multiple very low-cost, fully passively managed index mutual funds or exchange-traded funds (ETF) is the individual investor’s point-of-reference for optimal diversification. Investors should evaluate their investment strategy alternatives in the light of always having the choice of buying broadly diversified mutual funds and ETFs with relatively inexpensive trading and very low recurring management fees. Another kind of investment diversification that individual investors should consider important relates to the failure or corruption of the financial industry intermediaries and fiduciaries that hold individual investors’ securities. This meaning of diversification has nothing to do with scientific investment principles related to optimal portfolio diversification. However, it is still very important. Prudent investment practices would indicate that you should spread your investments across a variety of financial organizations, rather than

concentrating them all in just one or two places. With long-established financial institutions and with the various governmental regulatory oversight and protections that are in place, fiduciary risk tends to be relatively small, but it is still there. If an individual investor spreads investments across a variety of instruments with different firms to diversify away unsystematic risk, then that investor would also tend to be “diversified” with respect to the partial or complete failure of any particular fiduciary institution. Moreover, if a legitimate institution has some level of failure there may also be additional measures in place that protect some of the holdings of individual investors. These protections relate to fraud and the taking of assets and not to any protection for poor investment results. Finally, many fiduciary failure problems that are reported in the media relate to individuals who naively entrust large portions of their financial assets to non-mainstream persons or financial entities that are subsequently found to be fraudulent. Simply having a personal rule that you will NEVER NEVER NEVER EVER put more than a limited percentage of your liquid investment assets, for example 5% to 10%, into any single investment will force you to diversify and reduce your exposure to investment crimes. Stories about investment fraud often seem to include the phrase: "his or her life savings." There should never be a moment during your lifetime when your life savings are not heavily diversified across many investment vehicles and firms. There is no need to go to extremes about this. For example, holding your total investment portfolio in custody with a half dozen different investment firms -- with multiple, investment funds -- moves you toward both the scientific finance definition of diversification and theprudent fiduciary "diversification" definition. If your life savings are invested in just one place, first don't, but if you do, you had better do your utmost to conduct initial due diligence and ongoing monitoring. Even if you do, you should keep you fingers crossed at all times, because you just handed your financial fate over to a single party and all you eggs are in one basket. Just hope that they are not either inept or corrupt, when in custody of your personal assets.The practice of having your investment assets in the custody of multiple fiduciaries may be a bit more work, but it can have its advantages to you. If you use several financial services providers, you will be more aware of the services that they offer and will better understand what a competitive service offering is. On an ongoing basis, you can choose to make new investments among a wider set of offering. If you become dissatisfied with one of your financial industry vendors, you can just move your money to another. If you use multiple financial services companies to begin with and you have not made a mental "commitment" to just one or two, then you will be more open to evaluating new vendors and new services over time. Concerning disadvantages, if your investment assets are relatively modest, you may face somewhat higher fiduciary costs because you do not meet the asset breakpoints that financial firms use as an incentive for you to consolidate your assets with them. In addition, you may have to resist the efforts of stock brokers to consolidate your assets with him or her to get higher trading commissions. The same situation could apply with investment counselors and financial advisers who you regularly pay a percentage of your assets as a management fee. If they have more of your assets under management, they earn higher fees and this is the easiest way they can grow their revenues. When you attempt to do comprehensive lifetime financial planning in such circumstances, you could face further aggravation. If you use a financial planning advisor, who is compensated on the size of your assets, and he or she knows that you have assets elsewhere, you may have to resist continued entreaties to consolidate your assets. Alternatively, if you "hide" other assets held elsewhere from such a financial planning counselor, which many people do, then this could significantly distort the development of your lifetime financial plan. This is one very strong reason why you should separate the purchasing of investments from your efforts to develop and update a comprehensive financial plan. When you use a financial planner who you pay directly for financial planning services, either hourly or for the planning task, you can get a comprehensive plan without all the "gimme your assets to manage" routine. Also, if you use an objective planner, he or she should lead you to the lowest cost, most diversified index mutual fund and ETF investments.In summary, you have to be in charge when you invest your assets and deal

with financial intermediaries. It may seem easier to just consolidate your assets in one place and turn the keys over to someone else to manage your financial fate. However, you will never know whether you made a mistake, when you chose to hand all your financial keys over to just one party, until it is too late. If you prudently diversify among a reasonable number financial vendors, you will lower the potential impact of a financial "fiduciary" failure.

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