

Why is diversification valuable to individual investors?

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Summary: Diversification is an extremely important investment strategy for every individual investor, and it is a genuinely free lunch. Increased diversification reduces portfolio risk or price volatility without a corresponding reduction in expected portfolio returns. Thus, if you fully diversify, you get something free – lower risk for the same expected return. A very high degree of diversification can be achieved through investing in a variety of passively managed index mutual funds or exchange-traded funds. Such investments are also among the lowest cost investment vehicles available to individual investors in the financial markets. Given that this alternative is easily available, the relevant question is never whether a portfolio should be well diversified. Of course, it should be. Instead, investors should ask what the true cost of an under-diversified investment strategy would be to their long-term investment returns and overall financial welfare. Ultimately, there are numerous paths to achieve poorly- or well-diversified portfolios. Information in *The Skilled Investor* can help investors to understand better the tradeoffs between investment strategies in terms of returns, risks, costs, and one's personal financial management time commitment. In the end, the answers are simple: hold funds and not individual securities; own the market and not a subset of it. “Diversification: a bigger free lunch” Professor John Campbell of the University of Chicago reinforces the value of diversification and demonstrates that diversification has become even more valuable over time.¹ Professor Campbell observed that not only is diversification a free lunch, it has been more filling lately. He said, “economists are famous for pronouncing gloomily that ‘there’s no such thing as a free lunch.’ Yet, finance theory does offer a free lunch: the reduction in risk that is obtainable through diversification. An investor who spreads her wealth among many investments can reduce the volatility of her portfolio, provided only that the underlying investments be imperfectly correlated. There need be no reduction in average return and thus no bill for lunch.”² By imperfectly correlated, Professor Campbell meant that the prices of securities in a portfolio tend not to move up or down as a group in lock step. Price volatility is measured by the statistical variability of prices, which is a proxy for the riskiness of a particular investment. Information will affect the stock prices of individual securities differently. Professor Campbell reported that over time the average correlation in price movements between two randomly chosen stocks fell from the 25% to 30% range in the 1960s down to below 10% at the end of the 1990s. Professor Campbell also concluded that the benefits of diversification increased in the 1990s, because the volatility in the prices of individual stocks also increased. Several decades ago, a typical stock had volatility that was 35% higher than the market. In the 1990 that figure rose to 50%. With increased price volatility, diversification provides an even greater benefit. At the same time, however, one needs a greater number of stocks to achieve the same level of diversification compared to periods when stocks prices were less volatile. Professor Campbell also pointed out that the benefits of international diversification at the country and geographic sector levels had increased. For example, diversifiable price volatility at the country level increased from 9% annually in the middle of the 1990s to 12% annually in the late 1990s.

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2) *ibid*, p 14