Business Forum

COMMENTARY | Diversification as protection

TOO MUCH AND TOO LITTLE

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Guest Columnist

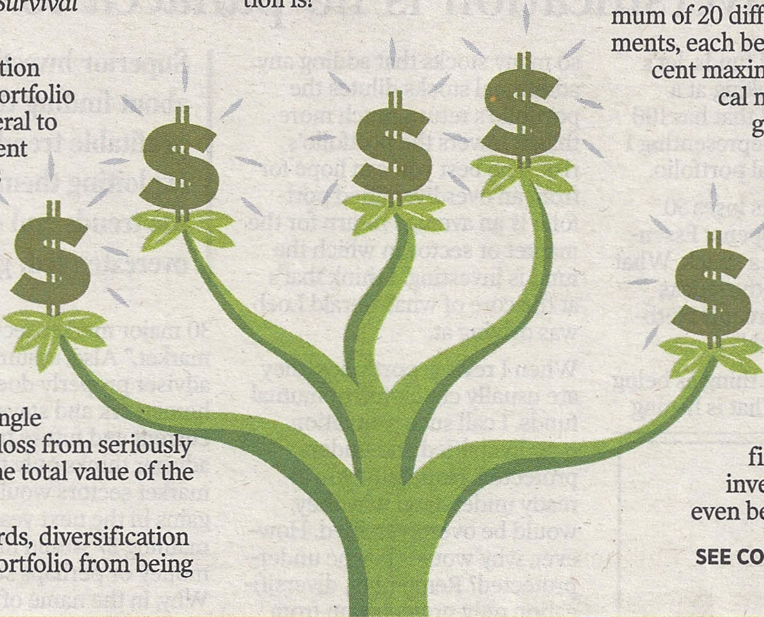
"Diversification is an admission of not knowing what to do, and an effort to strike an average."

— Gerald Loeb, *The Battle for Investment Survival*

"Diversification refers to a portfolio making several to many different investments — different stocks, bonds, real estate, gold, cash, etc. — in order to avoid a single investment loss from seriously damaging the total value of the portfolio.

In other words, diversification protects a portfolio from being decimated by a single investment loss. That's all it does. It is no panacea, no "holy grail" to successful investing.

Using a pure stock portfolio as an example, how would one decide what optimal diversification is?



The U.S. government generally requires ERISA-qualified plans — such as company retirement plans like ESOPs, profit sharing plans and 401(k)s — to not have a position in any one security exceed 5 percent of the portfolio. That would mean a minimum of 20 different investments, each being at the 5 percent maximum. As a practical matter, it generally means from 50 to 100 percent more investments, or from 30 to 40 different investments.

Except in a roaring bull market, do you have any idea how hard it is to find 30 to 40 good investments? It gets even better. If you hap-

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pen to find a really good winner in your portfolio, you have to sell at least part of it not to exceed the 5 percent maximum. Effectively, this means you have to sell your winners while you get to keep your underperformers and outright losers.

This is government policy at its best.

Looking at mutual funds, let's assume we are looking at a stock mutual fund that has 100 stocks in it, each representing 1 percent of the total portfolio.

If one of the stocks loses 50 percent, what happens? Essentially, nothing. It's a speck. What happens if one of the stocks gains 50 to 100 percent? Nothing. It's still a speck!

So, there is such a thing as being overdiversified. That is having so many stocks that adding any additional stocks dilutes the portfolio's return much more than it lowers the portfolio's risk. The best you can hope for from an overdiversified portfolio is an average return for the market or sector in which the fund is investing. I think that's at the core of what Gerald Loeb was driving at.

When I review portfolios, they are usually chock-full of mutual funds. I call such a situation overdiversified and underprotected. Hopefully, you already understand why they would be overdiversified. However, why would they be underprotected? Remember, diversification only protects you from the individual mistake. It does not protect you at all from a generalized sector or market downturn.

Looking at a hypothetical example, let's assume that there are 30 major market sectors in "the market." Also, assume that your adviser properly does his/her homework and stays on top of current and future trends. The adviser thinks only three of the market sectors would realize gains in the next year; the remaining 27 would likely lose money or perhaps stay even. Why, in the name of diversification, would you want your adviser to put you/leave you in the 27 other sectors or in the market as a whole?

> **Superior investing is about finding the profitable trends and exploiting them. When the trends end or look overextended, get out.**

In my opinion, superior investing is about finding the profitable trends and exploiting them. When the trends end or look overextended, get out. Control your risk by getting into cash, which, while not completely risk-free, is as close as you can get.

Do not invest in stocks or trends in which you don't have confidence. Keep researching until you find what you believe to be a reliable trend and then risk your hard-earned capital. Until then, stay in cash.

I think you need only to be diversified enough (within a trend or portfolio) to keep an individual trend or investment from ruining your portfolio's performance. I believe these to be the keys to not only superior performance, but also superior safety.

Ask anyone in many different mutual funds in the 2000-2002 period how much their diversification protected them then. Better yet, from 1929 to 1946 and from 1966 to 1982. Bear markets can last a long time. I don't believe we have yet emerged from the bear market that began in 2000.