PINNACLE
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What is Diversification and why do you need it?

Ask most people what asset allocation is, and they'll say, "Don't put all your eggs in one basket." Then ask them what diversification is. Again, they'll say, "Don't put all your eggs ..." The truth is, too many don't know the difference. With asset allocation, you define how many investment dollars you put in each of three major asset classes: stocks, bonds and cash and cash equivalents (plus a few others).

The investments within a class tend to behave similarly, so you want to allocate your investment dollars to different classes. But you'll also want to ensure that gains in one investment compensate for losses in others. That requires diversification.

What Is Diversification?

With diversification, you choose investments that would behave differently to unforeseeable economic conditions, even within the same class.

For example, if in early 2020 you were invested in hotel chain and airline stocks, they would both have fallen when the pandemic hit. But if you had hospitality stocks mixed with technology and health care, hospitality would have fallen while the others soared. So the winners compensated for the losers.

The number of different stocks you hold is also significant, needing ten or more to get much diversification. But managing large numbers of stocks is cumbersome. So what's the alternative?

Can You Use Funds as Diversification?

With funds, you purchase a small piece of an instrument that, for its part, is invested in a large number of companies. These could be mutual funds, index funds or exchange-traded funds (ETFs). In addition, you may want to invest in multiple funds that focus on different industry sectors, company sizes, geography and stock/bond blends.

But funds have costs – to pay for them to be administered and professionally managed. So you have to look carefully at how those costs affect the overall profit from the investments.

A popular way to solve that problem is to invest in a "lifecycle fund." A fund's aggressiveness is linked to the time remaining to the target date. So you pick your target date, and the fund manager "tweaks" the fund's investments: higher risk when far away and lower risk when you are close.

How Do You Diversify Within the "Stocks" Asset Class?

You can diversify stocks by industry sector, location and size of the company.

Sectors, in general, include energy, financials, industrials, health care, consumer staples, utilities and others. Each performs differently.

For example, consumer staples and utilities do well in down markets. Conversely, consumer discretionary spending and IT do well in up markets. And financials outperform when interest rates are high. The key is to balance between different sectors.

Location counts because market performance varies in different countries and regions. And varying the company size helps: smaller-capitalization companies tend to offer higher risks (and rewards) than larger-capitalization companies.

You'll also want a mix of value versus growth stocks. Value stocks – often household names – have long track records and bring security and stability. Growth stocks offer exceptional growth as they're linked to new technologies and megatrends.

How Do You Diversify Within the "Bonds" Asset Class?

Bonds basically let you loan money to a "bond issuer"— typically the U.S. government, a local government or a corporation. When your bond reaches maturity, you get paid back with a fixed amount of interest.

You can diversify your bonds by varying the type of issuer, the issuer's credit quality and the maturity date.

How Do You Diversify with Cash and Other Asset Classes?

The main risk with cash and its equivalents comes from the loss of value over time caused by inflation.

The risk with cash is low, but so is the return. You can earn small interest rates by placing cash in Treasury bills, bank CDs, corporate paper and other money market accounts. Or you can hold it in U.S. dollars and/or foreign currencies.

Are There Other Assets to Help Diversify?

You can diversify a portfolio by adding income streams such as pensions, annuities and long-term care insurance. In addition, real estate and commodities (including precious metals) can be good hedges against inflation.

What Are You Diversifying Against?

You diversify a portfolio to lower your risk of loss as you accumulate assets, but you need to see the type of risk you are taking on. Market risk (called systematic) includes factors like inflation, weather events or pandemics that affect whole markets and are beyond your control. But diversifiable risk (called unsystematic) comes from the sales and profits of companies themselves. These results ultimately affect the stock price. So here is where a properly diversified portfolio is able to provide significant protection.

Diversification allows you to feel more confident and for many, provides peace of mind during your investing years. But if you haven't looked at your portfolio recently, the likely risk of inflation is a good reason to do so.

- Thomas J. Roberts
Principal & CEO

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Disclosures

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value, and may trade at prices above or below the ETF's net asset value (NAV). Upon redemption, the value of fund shares may be worth more or less than their original cost. ETFs carry additional risks such as not being diversified, possible trading halts, and index tracking errors.

The principal value of a target fund is not guaranteed at any time, including at the target date. The target date is the approximate date when investors plan to start withdrawing their money.

Growth investments may be more volatile than other investments because they are more sensitive to investor perceptions of the issuing company's growth of earnings potential.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The fast price swings in commodities will result in significant volatility in an investor's holdings. Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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