Diversification Leads to a Tastier Portfolio

No matter the market, investors shouldn't lose an appetite for stocks.

by Jeffrey Steele

If you doubt diversification is among the most important keys to successful investing, consider this quotation from one of today's investing and financial experts: "The beauty of diversification is it's about as close as you can get to a free lunch in investing," said Barry Ritholtz, author, equities analyst and founder of the New York City-based Ritholtz Wealth Management.

In any one year, certain asset classes will lead the pack, only to fall off the next year and possibly sink to middle of the pack or endure the ignominy of becoming the worst performing. Meantime, the also rans or losers from last year rise to the top to become that year's stellar darlings.

But because no one can predict the future, it's impossible to say which asset class will outperform from one year to the next.

How does an investor deal with this uncertainty? Simply put, by diversifying your portfolio and making sure there are investments in all or most of the major asset classes. In the most fundamental sense, diversification lowers risk, said Aaron Cirksena, founder and CEO of MDRN Capital in Annapolis, Maryland. Spreading investments across different assets reduces the chance of losing everything in one ill-advised investment, he said.

John Wittelsberger, CFP® and financial adviser at Washington, D.C.-headquartered investment management service firm Armstrong, Fleming & Moore, is another outspoken proponent of the risk-reducing attributes of diversification.

While diversification may limit potential returns, it also reduces the impact of poor performance in a single investment, he said.

"Finding the ideal ratio of risk to reward is essential for long-term financial success," he added.

"An example of balancing risk and reward in an investing portfolio would be to allocate a percentage of funds to assets that are high-risk/high-reward, such as stocks in developing markets, while also retaining more stable assets, like government bonds or dividend-paying stocks."

Still another benefit of diversification is that it assists investors in gaining exposure to a broader range of investment opportunities, said Lucas Kiely, chief investment officer at digital wealth platform Yield App, based in Tallinn, Estonia.

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What's more, a number of those investment opportunities gained through diversification may be across the globe, said Adam Koprucki, founder of RealWorldInvestor.com. Investing globally can unveil new opportunities, "especially in emerging markets that may outpace the domestic market," he observed.

CHANGING OVER TIME

Diversifying your portfolio is among the smartest strategies an investor can make, said Wittelsberger. "The state of the economy is always subject to change, and markets are dynamic," he said. "Having exposure to a variety of sectors in a diversified portfolio enables investors to adjust to shifting market conditions. To make sure your portfolio is in line with your financial objectives, you have to review and adjust it on a regular basis. During economic downturns, for example, adjusting to market conditions may entail transferring money from equities to defensive assets like utility stocks or gold."

Investors' approaches to diversification should change and evolve over time, staying in pace with the growth of their portfolios, said Kelly Ann Winget, CEO, founder and fund manager of Dallas-based Alternative Wealth Partners.

While still in their younger ages, the lengthy number of years ahead of investors allows them to be aggressive with a more diversified and high-risk strategy, she said. True wealth accumulation depends on investors' willingness to invest across a number of assets classes, not just stocks, mutual funds, bonds and real estate, but across various sectors, including businesses, supply chains, public stocks, insurance and private equity, she added.

In addition to changing in step with their portfolios' growth, investors should adapt their diversification strategies to align with evolving market dynamics and personal financial goals, said Eric Satz, CEO and founder of alternative asset platform Alto, based in Nashville, Tennessee. Embracing alternative assets, e.g., real estate, commodities, art, etc., within the portfolio can provide enhanced diversification and potentially greater returns, he noted. "Flexibility and responsiveness are key as investors navigate the ever-changing investment landscape, ensuring continued portfolio growth and resilience," he said.

TYPICAL APPROACHES

The most common diversification strategy is to diversify by asset allocation, as in a mix of stocks, bonds and real estate. BetterInvesting members focus on investing in stocks diversified by sector, industry and company size.

Investors may also wish to diversify by investment style such as growth and value. Growth stocks typically offer high earnings and growth potential, while value stocks are generally undervalued relative to their fundamentals.

Like anything else, diversification is not without downsides. Investors may overdiversify, leading to losing track of some of the assets and how they work. Tax implications may result for those who fail to undertake appropriate tax planning, given the fact different asset classes are taxed differently. And, of course, by transitioning money from a single asset and diversifying into many different assets, investors may sacrifice high returns in the event of that one single stock, mutual fund or exchange-traded fund (ETF) that ends up soaring in value.

But when all is said and done, investors who reap success over time are known for their capacity for patiently holding well-diversified portfolios of high quality investments through market fluctuations.

"Building a diversified portfolio is a long-term strategy aimed at wealth accumulation and preservation," Wittelsberger said.

"Making regular contributions to a retirement account and enduring market fluctuations by maintaining investments in a well-diversified portfolio including quality growth stocks is a solid long-term investment strategy."

Investors who reap success over time are known for their capacity for patiently holding well-diversified portfolios of high quality investments through market fluctuations.

→ Adjust your portfolio on a regular basis.

→ Be aware of changes in market conditions.

→ Be sure you invest in a variety of sectors.