



The Osbon Minute

Beware Faux Diversification

Diversifying a portfolio has never been easier. With hundreds of ETFs and thousands of money managers available, investors can easily spread their assets across many securities. However, many portfolios are much less diverse than their owners may realize. With bond and stock market turbulence running high, now is prime time to check for faux diversification.

Faux diversification is a made-up term for a very real investment hazard – the faulty assumption that holding many securities provides protection against the legendary risk of carrying too many eggs in one basket.

Of eggs and baskets

Reaching a high level of diversification involves two distinct elements. Think of it as filling multiple baskets with multiple eggs.

Let's start with the eggs. Holding just a few stocks creates needless exposure to company-specific problems, such as lawsuits or shoddy management or poor financial performance. Diversifying with fifty, one hundred or more stocks instead of two or three greatly reduces this exposure and the risk that comes with it. The same is true with bonds, of course.

But there's more to diversifying than just increasing the number of securities held. The other phase of diversification is carefully choosing the distinct asset classes (baskets) in which securities are held. As different asset classes often move in divergent directions or at different rates in response to economic, political or regulatory developments, owning multiple asset classes, weighted to balance expected risk and return, provides a shock absorber against the extremes of volatility.



Fighting your faux

Faux diversification results when an investor owns many eggs but too few baskets. Owning only the S&P 500 – or spreading money around only to three money managers who all concentrate in large cap domestic stocks – may feel like diversification, but it is the incomplete, faux variety. Instead, most investors should consider a broader palette – such as equities of large and small companies, growth and value, domestic and international, plus bonds, and in some cases, gold, currencies, and/or real estate. For all but the most risk-preferent investors, this variety allows more restful sleep during stormy market phases.

Is the diversification of your own portfolio real, faux, or something in between? The only way to know is to look under the hood of all holdings. Money managers who market their strategies with different-sounding names like “Growth,” “Total Return” or “US Strategic” may in fact hold very similar securities. If so, investing with more than one of them adds little risk protection to a portfolio.

If you’re not so sure about the baskets you own and what’s in them, we can analyze your current portfolio and help you evaluate where you are on the diversification scale.

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Next time: The fallacy of annualized return.

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