The Value Line Family Of No-Load Mutual Funds

NewsAlert

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Back To Basics: The Importance of Diversification

Most investors heed the timeless advice to avoid putting all of their eggs into one basket. Today, asset allocation is a common term among investors who have balanced their portfolios at least among the primary asset classes of stocks, bonds and cash. Cash investments are included because they provide investors with easy access to their money and have very little risk of loss. Bonds are seen as income generators in a portfolio, providing higher yields than cash. And stocks are included for their growth potential. In fact, stocks have historically grown faster and outpaced inflation better than either bonds or cash.[1]

The goal of diversification is to enable investors to tap into the benefits of each asset class while minimizing the risk associated with any one of them. When one element of a portfolio is doing poorly, another may be strong. However, diversification is much more than dividing a pie of assets into three or four pieces. There are many ways to diversify and many ways to help ensure that portfolio volatility is kept to a minimum.

Volatility: The Real Reason to Diversify

Earlier this year, this newsletter featured a brief lesson on the power of compounding. The basic tenet was that your money grows faster if you keep it invested and reinvest all dividends and capital gains. We also saw that the earlier you start investing – that is, the longer you can allow your money to stay invested – the better the outcome. Each year, you earn returns on your original investment plus the earnings from prior years.

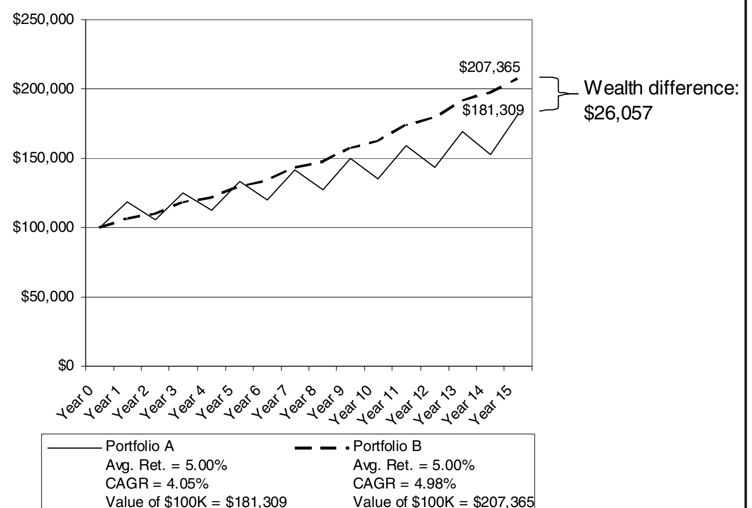
For example, let's say you invest $1,000 one year and earn 5% on it. Your money would grow by $50 to $1,050. The next year, you earn 5% on the $1,050, growing it by $52.50 to $1,102.50. Although you earned the same return of 5% in year two, your money grew by a higher amount than it did in year one. That's compounding.

However, compounding is less effective when returns are volatile. Using our example above, suppose instead of earning 5% in year two, you lost 5%. Your investment would decline to $997.50. In year three, if you earned 5% again, your money would grow to $1,047.38. You can see that with the less volatile returns in our first example, your money would build up much faster. In theory, the returns from a diversified portfolio will be smoother – or less volatile – than the returns would be from any individual investment in the portfolio.

The accompanying chart shows a compelling example of how volatility affects compound returns. Both portfolios have the same average return of 5% and the same starting balance, but one of them is much more volatile than the other. The less volatile portfolio accumulates $25,000 in additional wealth compared with the more volatile portfolio.

How Volatility Affects Compound Returns

Two portfolios can have the same average annual return and starting balances, but turn out very different long-term results if one portfolio is more volatile than the other. In this example, both portfolios start with $100,000 and earn an average return of 5% per year. After 15 years, the less-volatile portfolio accumulates more than $25,000 in additional wealth. Diversification is one way to achieve lower portfolio volatility.



Making the Most of Diversification

Asset allocation is only the beginning of diversification. Within each asset class, there are ways to help ensure diversification does its work to minimize volatility in your portfolio.

Among equity holdings, one way to diversify is by adding global exposure to your portfolio. Many equity mutual funds offer an element of global diversification, either by direct investment in foreign companies or by investing in U.S.-based multi-national firms.

You can also gain diversification benefits by combining mutual funds that have different investment styles. For example, large-company stocks may perform differently from small-company stocks, depending on economic and market conditions. Small-cap funds that invest in smaller companies can offer greater reward potential than large-cap funds, albeit with increased risk. Likewise, growth stock funds invest in companies with strong growth potential while value funds invest in companies that appear undervalued. Performance from these two styles can be very different; we showed in the last issue of this newsletter that large-cap growth stocks had been outperforming large-cap value stocks in 2008.

Another way to diversify is with higher yielding equities that are often viewed as defensive holdings in uncertain times. You can typically find these types of stocks in a mutual fund whose primary objective is income. Similarly, mutual funds of convertible securities are likely to emphasize capital growth as well as income. Depending on your tolerance for risk, you could choose to divide your equity holdings among large caps, small caps, convertibles and income funds.

Most equity mutual fund managers diversify their portfolios along sector lines, knowing that certain industries benefit more than others depending on the state of the economy. For example, cyclical companies, such as auto makers, may suffer greatly when the economy is weak, whereas consumer staple companies, such as healthcare providers, tend to be more immune to the swings in the economy. Capturing various industry sectors in a portfolio may help minimize its volatility as the economy moves through its cycles.

There are also diversification opportunities among fixed income investments. For example, you could include both taxable and tax-free bond funds in a portfolio. Likewise, government bond funds offer greater safety, while lower-rated corporate securities, such as those found in aggressive income funds, may provide higher yields, although they will also have greater risk.

Solutions for Today

No matter what the conditions in the markets, diversification is always a good policy. Take some time to evaluate your portfolio to be sure it is adequately diversified. If you have a large position in any one stock, consider selling some of it and diversifying the proceeds. If any individual mutual fund accounts for a very large portion of your wealth, be sure it is diversified or consider spreading the investment among different types of funds.

Remember that combining a range of investments, styles and sectors may help to smooth the volatility of returns that could occur in your portfolio. And, all else being equal, consistent returns mean a higher compounded growth rate on your money.

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[i] Siegel, Jeremy J. Stocks for the Long Run, 4th ed. New York: McGraw-Hill, 2008.

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