

Reducing risk with a diversified portfolio

Diversification is a fundamental investment concept that most investors have no trouble understanding. If, for example, an investor owns equal dollar amounts of only two stocks, and one suffers a 50% loss, his or her portfolio has gone down in value by 25%. But if the investor owns ten stocks, and one drops by 50%, his or her portfolio has suffered only a 5% loss.

With a diversified stock portfolio, risk is reduced because different stocks rise and fall independently of each other. On a broader scale, combinations of different investment assets may well cancel out each other's fluctuations in price, reducing the overall risk.

Categorizing risk

The ultimate goal in a diversification strategy is to improve investment performance while reducing risk. One way to categorize risk is to distinguish between *unsystematic risk* and *systematic risk*.

Unsystematic risk is risk that is specific to a company. Often, this risk involves some kind of dramatic event such as a strike, a fire or some natural disaster. A company's slumping sales also fall within this category. Diversification among the stocks of many companies reduces unsystematic risk because, of course, it's highly unlikely that every one of the unhappy events listed above will occur in all companies.

Conversely, some events can affect *all* companies at the same time. This systematic risk includes such occurrences as inflation, war and fluctuating interest rates—generally, those events that influence the entire economy. Of course, diversification cannot eliminate the likelihood of these events happening. Systematic risk accounts for most of the risk in a diversified portfolio. However, in exchange for enduring systematic risk, investors may be rewarded in terms of their investment return. There is no reward for taking on unneeded or unsystematic risk.

A diversified stock portfolio: how much?

One way that academic researchers measure investment risk is by looking at stock price volatility. A classic 1968 study by J.L. Evans and S.H. Archer, "Diversification and the

Reduction of Dispersion,” concluded that an investor who owned 15 randomly chosen stocks would have a portfolio no more risky than the market as a whole. This research confirmed earlier advice, coming from instinct and experience, that Benjamin Graham gave to investors in his 1949 book, *The Intelligent Investor*. Graham recommended owning from ten to 30 stocks to achieve proper diversification.

A study published in 2001 (“Have Individual Stocks Become More Volatile?” by John Campbell, Martin Lettau, Burton Malkiel and Yexiao Xu) suggests that those numbers may be too small. To replicate the risk of the market as a whole, according to the study, the “excess standard deviation” of portfolio returns needs to be brought down to 5%. In the 20 years ending in 1985, an investor could have achieved this goal by owning 20 stocks. But, in the period from 1986 through 1997, the professors concluded that one needed to own 50 stocks to reach the same result!

Choices in diversification

Of course, an investor who invests for income will diversify his or her holdings among different bonds. In this case diversification usually means owing long-, intermediate- and short-term government bonds. Other categories might include, when appropriate, municipal, corporate and, sometimes, high-yield (“junk”) bonds.

For some investors the goal of diversification within an asset class can be achieved relatively easily by purchasing shares in a mutual fund, which, by definition, offers automatic diversification.

It is possible for an entire asset class to do poorly for an extended period of time (as we have seen in recent years). Therefore, it’s a common diversification strategy for investors to spread their money across asset classes—including, for example, stocks, bonds, money market funds and real estate—in their portfolios.

Finally, some investors may want to think in global terms. By investing outside of the U.S., investors are addressing the risk of extended bear markets at home. Global investing includes additional risks, however, such as currency fluctuations and political uncertainty.

May we offer our assistance?

Risk always will be a cause for concern. There's always a fear of the unknown. Still, knowledge and experience can help improve the odds that you'll achieve success as an investor in the long term.

We'll be glad to help you develop a strategy that meets your specific needs as an investor. One designed and implemented to take only the risks with which you are most comfortable.

We look forward to the opportunity to tell you more.

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Any developments occurring after January 1, 2008, are not reflected in this article.