The 6 Stages of Diversification – Where Are You At?

I had an interesting question via Twitter:

It got me thinking about diversification. There are actually multiple levels or stages of diversification, with a diminishing amount of importance as you move down the list. So while Dr. Hersch might feel he is diversified, and likely is at one level, I feel he isn't because he hasn't diversified enough of these stages to actually be diversified. Let's go through the six levels and discuss them. Also, at the end, I'll throw in a few comments about the idea of overdiversification.

Diversification Level 1: Multiple Asset Classes

The most important ratio in your portfolio is your stock to bond ratio. This will dictate at least 70% of the performance of your portfolio. In the case of the tweeter above, there is one asset class. A stock to bond ratio of 100:0. Since this is the most important type of diversification, I would dispute the "I am diversified" statement on this alone. Other major asset classes include real estate, precious metals, commodities etc.

Diversification Level 2: Multiple securities

The next most important level is simply owning a lot of different securities. If Enron goes out of business or Argentina defaults on its bonds, you don't want to be the one left holding the bag. Actually, it's fine to be holding the bag, as long as it is one of 5,000 bags you're holding. Then it won't have any significant effect on your portfolio and especially your financial goals.

Diversification Level 3: Multiple types of securities

What am I talking about here? I'm talking about sub-asset classes. US stocks, developed market stocks, and emerging market stocks for instance. Financials, utilities, staples, and energy stocks. Or corporate, treasury, and inflation-protected bonds. Or single family, multi-family, retail, and industrial real estate. Gold, silver, and platinum. Oil, corn, and pork bellies. Yen, dollars, Euros, Pounds, Renminbi and Bitcoin. You get the point. Even if you own 50 different stocks, if they're all financial stocks, you're not that diversified.

Diversification Level 4: Multiple Factors

We're getting into less important levels now, but even within the passive investment community, there is a great divide between the slicers and dicers and the total market folks. The total market folks believe that the most diversification you can get is to own all the securities in an asset class in a market capitalized manner. So if Apple is bigger than Caterpillar, more of your money is in Apple. Slicer Dicers believe in "factors," the idea that true diversification comes from "tilting" the portfolio toward small, value, momentum and/or dozens of other factors that academics have "discovered" (usually by massaging retrospective data.)

If you believe the past is indicative of the future and that these factors are real, being diversified means tilting the portfolio toward them. If you don't, skip this level of diversification. Personally, I think they're probably real so I tilt my portfolio a bit, but not more than I'm comfortable with if it all turns out to be data-mining on a very limited set of data.

Diversification Level 5: Multiple Managers

If significant active management is being used in your portfolio, you may wish to have multiple managers doing it. It may turn out one of your managers is really untalented or even a thief. If you're using passive (usually index) funds run mostly by a competitor, this is less of an issue. In most areas of my portfolio, this isn't an issue for me. I'm perfectly comfortable having a single Vanguard computer system run all of my index funds. But when I branch out into other things (like the 5% of my portfolio I invest in hard money loans) I prefer using 3 different managers to do so.

Diversification Level 6: Multiple Companies

I often get asked whether it's safe to have all of your money at Vanguard or whether some should be put at Fidelity or Schwab or eTrade. Frankly, I think it's fine to have all your money at Vanguard (or even all at one of the other major mutual fund or brokerage firms) but if that makes you worry, all it will cost you (and your heirs) is a little extra hassle to spread it around a bit. One situation where it can really make sense to go with multiple companies/banks is if you are investing in CDs. If you go to a new bank, you get a new FDIC limit, which has a certain amount of value.

Overdiversification

Is there such a thing as overdiversification? Of course. The more managers, companies, factors, and investments you own, the more hassle you're going to have to deal with in your life. But what people are really talking about when they use the term overdiversification is false diversification. That's when you own 16 different actively managed large cap stock mutual funds. Yes, there are 16 different managers, but they're all buying the same stocks. You'd probably get more REAL diversification just buying the Vanguard Total Stock Market Index Fund.

Investment collectors and those dealing with poorly trained "financial advisors" get into this trouble too. They end up with a portfolio of 31 mutual funds, 16 individual stocks, 5 muni bonds, three annuities, bitcoin, your brother's failing business, and a whole life policy. That isn't a portfolio, that's a mess.

The Solution?

The solution to this dilemma is to own a low-cost, broadly diversified mix of stock, bond, and real estate index funds. That gives you the first three levels of diversification. If you want to go for level four, add a fund or two to tilt the portfolio. If you get into private real estate funds or syndications, be sure to use multiple managers (level 5). If you're a little paranoid about Vanguard, move a little money somewhere else.

There you go. Diversification complete. Can you still lose money in a bear market? Absolutely. But those losses are going to be both limited, temporary, and easily endured because you know you are following a reasonable investment plan. All you have to do is rebalance, continue to contribute, and enjoy the ride back up the other side of the valley. And it turns out that Dr. Hersch is more diversified than the original tweet would lead you to believe:

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I have a good amount in Real estate and about 10 percent bonds across multiple accounts. Maybe 60 -70 percent stocks overall. I'd have to look. But if the market

What do you think? What does diversified mean to you? How do you know when you're diversified? Comment below.