# Adding New Asset Classes To Your Portfolio

*[Editor's Note: This is one of my columns written for [MDMag.com (Formerly Physicians Money Digest)]() and grew out of a conversation I had with [Rick Ferri]() at [Bogleheads 12]() about adding new asset classes to a portfolio.  I hope you find it helpful.]*



The benefits of having [several different asset classes in your portfolio]() are well-known. There are dozens of increasingly exotic asset classes available to invest in, including frontier market stocks, U.S. small growth stocks, Japanese real estate, and British inflation-indexed bonds. An investor need not invest in all of them in order to be successful in reaching his financial goals.

The point of holding multiple asset classes is to boost returns and decrease risk through [diversification](). Since neither you, nor I, can predict the future, you want a portfolio that is going to do acceptably well no matter what happens in the world.

Consider these guidelines when deciding whether or not to add a new asset class to your portfolio.

# 7 Guidelines for Adding New Asset Classes to Your Portfolio

## #1 Number of Asset Classes

If your portfolio currently contains only one or two asset classes, you will almost surely benefit from adding another one.

Although the benefit of adding an additional asset class to the portfolio goes down with each new asset class, the benefits can be dramatic initially. As you add more classes, you are weighing the additional diversification against the added complexity and expenses inherent in a more complicated portfolio.

An investor with a tiny portfolio relative to what he will eventually need to retire can start out with a single asset class, since the effect of additional savings will dwarf the effect of the investment returns of the portfolio. As the portfolio grows, he will want to consider additional asset classes to provide diversification.

As a general rule for a portfolio of reasonable size, I would consider a bare minimum of three different asset classes. Seven asset classes provide a great balance between diversification and complexity. There is very little benefit to additional asset classes once you get to 10. Rather than adding an additional class to an already complex portfolio, perhaps you should consider replacing one that you currently have instead.

Chasing pandas, not returns

## #2 Avoid Performance Chasing

The addition of new asset classes to a portfolio is often used as an excuse by the investor to engage in the harmful practice of performance chasing. Investors consciously and subconsciously project the recent past into the future, despite the well-known fact that past performance is no indication of future returns. As such, it was popular to add small value stocks and REITs to portfolios in 2003-2007 and to add gold and long-term treasuries to portfolios in 2010-2012.

These days, after years of outstanding stock performance, investors are talking about a “100% equity” portfolio again. While adding any of these asset classes to your portfolio may make sense for the long run, be sure to carefully examine your motivation to ensure you’re not just chasing performance. If you’re convinced an asset class belongs in your portfolio, consider adding it after a period of poor performance, rather than when it is the “hot” asset class.

## #3 Low Correlation

When adding an asset class you want to make sure it is fundamentally different from what you already own.

Bonds are loans to companies or governments. When you own a stock, you own part of a company and share in its profits. REITs invest primarily in real estate and have a different tax structure than a more typical stock. It is easy to argue these asset classes are fundamentally different. Likewise, long-term Treasury bonds have different risk characteristics than short-term corporate bonds. You're looking for asset classes with relatively low correlation with one another.

On the other hand, if you have a portfolio consisting of large growth stocks and small value stocks, adding some large value stocks (which have relatively high correlation with the other asset classes you hold) probably isn't going to get you the bang for the buck you would get from adding some bonds or real estate (which have a much lower correlation with the stocks you already hold).

Historical correlations are relatively easy to look up. Correlations vary over time, but you're looking for an asset class that is non-correlated with your current asset classes as much as possible.

## #4 Positive Real Returns

Just about anything and everything – including stocks, bonds, precious metals, art, timber, whole life insurance, and horse manure – can be considered an asset class. Low correlation with the rest of your portfolio is important; however, it is also important to have asset classes that are expected to provide a positive, after-inflation return. You're investing, not just collecting. If too much of your portfolio is in asset classes with a low expected return, your entire portfolio may not have a return sufficient to meet your goals. Gold is a classic example. If you had an ounce of gold 500 years ago, you could use it to buy a man's suit. Today that ounce of gold still just buys a man's suit. Given our current historically low interest rates, many fixed income asset classes currently don't have expected returns higher than inflation. While there is some argument for holding an asset class or two without an expected positive real return in your portfolio simply for the overall diversification effect on the portfolio, you certainly want the vast majority of the portfolio to beat inflation.

## #5 Accessibility

For many years, an investor was only able to invest in a few asset classes because others simply weren't accessible in a way that allowed an investor to be diversified within the asset class at a reasonable cost. If there is no mutual fund or ETF that allows an investor to easily purchase dozens or hundreds of stocks, bonds, or properties at a reasonable price, the asset class really isn't particularly accessible.

In recent years, dozens of previously inaccessible asset classes have become accessible thanks to the explosion of the index fund and ETF markets, providing investors many new options.

## #6 Liquidity

When adding an asset class to a portfolio, an investor ought to consider her liquidity needs. While a typical investor doesn't need instantaneous liquidity for his entire portfolio, it is important to be able to have a reasonable amount of liquidity in the portfolio for unforeseen personal needs, investment opportunities, and portfolio rebalancing.

If most of your portfolio is tied up in individual real estate holdings, hedge funds, and other private investments, you should lean toward an asset class that can be liquidated any time the markets are open, such as publicly traded stocks and bonds.

## #7 Tax Implications

An investor who has very little tax-protected "space" in his portfolio (such as IRAs and 401(k)s) may find that the diversification benefits of a particularly tax-inefficient asset class such as REITs or TIPS may not be worth the additional tax cost. He may instead prefer to invest in tax-efficient stocks, municipal bonds, and individual rental properties.


Likewise, an investor whose portfolio is primarily tax-protected can consider high turnover stock asset classes (like microcaps) and particularly tax-inefficient asset classes such as Peer to Peer Loans. Even within a taxable account, investors with high taxable income are much more likely to benefit from adding an asset class such as municipal bonds than an investor with a lower income.

While a wise investor rarely changes his investment plan, there may come a time when the inclusion of a newly-investable asset class in the portfolio is prudent. Use these guidelines to help you decide whether the benefits of adding an asset class outweigh the downsides.

*What other factors help you decide whether or not to add a new asset class to your portfolio? Comment below!*