Eagle Strategies LLC

Investment

PLANNING ESSENTIALS

The Role Diversification Plays in Managing Investment Portfolio Risk

One of the most widely used techniques to manage investment risk is diversification. During any economic situation—a booming economy or an economic recession—some investments will perform well and other investments may underperform. By incorporating a mix of investments into a portfolio, the risk and reward may balance out.

Diversification relies on the fact that all investments have different ways of reacting to economic conditions. When investments are positively correlated, they act the same way during similar market conditions. When they are negatively correlated, they act in opposite ways. When they are non-correlated, their actions are not connected in any way.

KEY TAKEAWAYS

1. **Asset allocation is the first step in building a diversified portfolio.**

2. **Diversification helps manage risk and return better than a single or more concentrated investment portfolio.**

3. **Investments can react differently to the same economic conditions.**

4. **Diversification can help take the emotion—highs and lows—out of investing by managing risk and return.**

A well-diversified portfolio generally contains investments that perform differently at the same time. When some investments are increasing in value, others may not be going up as much and some may just be maintaining their value or going down in value. When looking at overall portfolio performance, the investments performing well are dragged down by the investments that are underperforming. However, at the same time, the underperforming investments are elevated by those that perform well—balancing out the highs and the lows.

Without diversification, more volatility may occur when looking at the value of the investments—and for many investors, that can be pretty difficult to stomach from day-to-day. This doesn't mean that overall portfolio value will never go down, but the overall experience will be less bumpy and dramatic.

STRATEGIES TO DIVERSIFY YOUR INVESTMENT PORTFOLIO

An investment portfolio can also be diversified through asset allocation—by investing in different asset classes. The most common of these are stocks, bonds, and cash—which helps manage risks and returns. While there have been times when stocks and bonds did not react in the same way to market conditions, there have also been times when they have moved more in unison. Therefore, asset allocation alone isn't enough to fully diversify a portfolio.

An additional way to diversify a portfolio is to allocate across a variety of investments within each asset class. For this example, let's look at the stock allocation of the portfolio above and examine ways the stock allocation can be diversified among individual investments.

MARKET CAPITALIZATION

Another way to diversify is through market capitalization. Market capitalization refers to the market value of a company's outstanding shares. If a company's current share price is $50 a share and it has 100,000 outstanding shares, its market capitalization—or market cap—would be $5 million.

Companies are categorized into large-cap, mid-cap, small-cap, and micro-cap. Large-cap stocks are generally those with a market capitalization of $10 billion or more. Mid-cap stocks are generally defined as those with a market capitalization between $2 billion and $10 billion, small-cap stocks are those with a market capitalization between $300 million and $2 billion, and micro-cap stocks are those with a market capitalization less than $300 million. Historically, market capitalization has been a good way to diversify investments.

COUNTRY/REGION

When we talk about "the market," we usually think of mostly U.S. companies—especially those that make up the Dow Jones Industrial Average or the S&P 500. But today's investment landscape is a global one—and investing in other countries and regions can help diversify your portfolio. International markets (outside of the U.S.) and emerging markets (regions/countries that are developing) can provide an alternative to holding all U.S. equity investments.

SECTOR

Stocks can also be diversified across different sectors or industries. Healthcare, Financials, Energy, Utilities, Technology, and Consumer Staples are all examples of sectors. In the chart to the right, you can see how different sectors within the S&P 500 performed over a one-year period. Since not all industries react the same way to economic conditions, diversification by sector can be a smart way to balance your risk and return.

TOP SECTORS	WEIGHT %
Information Technology	25.74
Healthcare	15.82
Financials	11.67
Consumer Discretionary	9.80
Industrials	8.65
Communication Services	7.28
Consumer Staples	7.20
Energy	5.23
Utilities	3.17
Materials	2.74
Real Estate	2.70

GROWTH AND VALUE

Stocks are also differentiated by type—the most common being between value and growth stocks. Growth stocks are those that are viewed as having the potential to outperform the market and often have a higher price per share. Value stocks tend to be underrated—"undiscovered gems"—with strong fundamentals that are not reflected in the share price.

While investments can be classified in many ways, the classifications can be drilled down even further for more diversification. For example, large-cap value stocks and large-cap growth stocks can be included within an overall stock allocation and can be broken down even further into U.S. large-cap growth stocks and U.S. small-cap growth stocks.

DIVERSIFICATION IN BONDS

In the case of bonds, they can also be diversified to manage risk. Bonds can be broken into corporate bonds, government and agency bonds, municipal bonds, and mortgage-backed securities. Within each of those categories, there will be differences in the credit ratings, duration, and the types of businesses or governments issuing the bonds. All of this helps further diversify an investment portfolio.

DIVERSIFICATION BY INVESTMENT ACCOUNTS

And while diversification by investment accounts may not directly impact portfolio risk, it can impact the portfolio return you receive after taxes. Since investments can be held in taxable accounts as well as tax-deferred accounts (such as an IRA), where the investments are held can also be part of an overall diversification strategy that would help manage investment returns and taxes. By placing assets within a tax-deferred account, you can help manage your tax liability until you are retired and most likely in a lower tax bracket.

While asset allocation and diversification cannot guarantee a profit or protect against losses, over time, a properly allocated and well-diversified portfolio is designed to provide competitive returns while reducing overall market risk.

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