Principle 4: Diversify

[Applause]

Christine Benz: Me again. I have some of the easiest units in the course here because I think these are things that most of us agree upon. But I'm going to talk a little bit about the merits of diversification. I think most of us fully understand the value of asset class diversification, intra asset class diversification. But I'm going to dive into that a little bit. I'm also going to talk about time period diversification which I touched on in my earlier comments about dollar cost averaging.

So Jack Bogle once again said it really well about the merits of diversification. He said absolutely no one knows what the stock market is going to do tomorrow, let alone next year. Nor which sector, style, or region will lead and which will lag behind. Given this absolute uncertainty, and I can just hear it in his booming voice, the most logical strategy is to invest as broadly as possible.

Noble Laureate Harry Markowitz said a version of the same thing.Markowitz, of course, was the path-breaking researcher and modern portfolio theory. He said of diversification, a good portfolio is more than a long list of good stocks and bonds. It is a balanced whole providing the investor with protections and opportunities with respect to a wide range of contingencies.

So both Bogle and Markowitz said here that there's so much that we don't know about the future. We don't know what the next catastrophe or wonderful thing to come along might be. And so the best idea is to invest with humility. Invest with a sense that we can't predict the future. So the best way to go is to build a portfolio given our time horizon that helps set us up for reasonable returns regardless of what happens.

So the key benefits of diversification. I'll just quickly outline one is that it helps ensure that at any given point in time something, anything, in your portfolio is performing reasonably well. In 2022, unfortunately, that's a really short list of like cash. Not great, even on an inflation-adjusted basis, but at least positive. Value stocks have certainly held up better than growth this year. Energy stocks, at least until recently, had done reasonably well. So there have been a few bright spots. But that's the value of diversification. That you've always got something in your portfolio that works.

Diversification also guarantees that you won't choose precisely wrong either about the asset class or the specific stock within the equity asset class, or the specific time period in which to invest. So it helps minimize regret, which it turns out is a really valuable thing in terms of helping us stick with our plan.

And finally diversification helps reduce the volatility of our portfolios. So just having things in our portfolios that behave differently helps bring the risk down. It helps bring the standard deviation down. Again that helps us stick with our plans.

So this is a slide. I'll just describe what we're looking at.This is something that my colleague Amy Arnott put together, but we did some research where we looked at correlations among asset classes. And what you can see, and maybe you can't see, maybe it's too tiny, but what you can see is that the more assets that you add, that helps reduce the standard deviation or the volatility of the portfolio. And that's especially true if you add assets that behave differently.

So Alan was talking a little bit about the value of doing that. So as you see things really taper down there in terms of standard deviation. That's more assets and that's more assets that are uncorrelated. Focusing on those two things can help bring down the risk, level the volatility level of a portfolio.

So there are multiple ways to diversify. I hinted at a few of them by asset class. That's the one that most of us think about and Jim Dahle talked about the value of asset class diversification in terms of how our portfolios behave in terms of their returns but it also translates into how it behaves in terms of volatility.

So asset class diversification, that's usually most of our first stop on the road to diversification within asset classes. Also super important, so you want stocks in your portfolio. You don't just want a couple of stocks, right. That's something Bogleheads know. They know the value of diversifying across multiple stocks, which is something that you get with those big broad index fund portfolios across account types.

Jim Dahle talked about tax diversification. It's something we don't talk about as much, but when you come into retirement and you have multiple pools of assets that you can pull from, that tax diversification really comes in handy.

And finally by time period, that diversifying your purchases by time period helps ensure that you have a variety of market returns that each dollar is able to benefit from.

This is just a slide that illustrates asset class diversification. I pulled this from some of our research on asset correlations. What you can see is that at least until prior to 2022 stocks had a nice, not fully negative correlation with U.S treasury bonds. But in some market environments, indeed a negative correlation. We've seen a little bit of a reversal of that this year where stocks and bonds have been moving in sympathy, but in many market environments we have seen that nice diversifying ability for those two assets.

And cash is the other asset class that appears on this screen. But remember you can overdo diversification. It's diversification not, I think Rick Ferri said, maybe someone else did as well, it's not de-wersification. And this is such an important point, that you can overdo diversification. In fact I would say this is one of the main problems I see in the portfolios that I review for these portfolio makeovers that I do.

People have portfolios that are crazily complicated given their assets. They've assumed that more is more. And I do wonder if there's a little bit of a wealth effect. That people feel like they've assembled a lot of funds or a lot of investments in a portfolio, even if they just have little bits in them, I think it might make them feel wealthier. But the problem with overdoing diversification is that it makes it really difficult to see what you've got. It makes it difficult to keep track of your portfolio's asset allocation. Makes it difficult to figure out where you need to make adjustments if your asset allocation gets off track.

So less is more in terms of moving parts in a portfolio. My view is that you can be quite minimalist on a per account basis, and you can even be minimalist across account types. In fact I was recently working with a woman on her portfolio makeover and she had a really good equity fund in her 401-k and they wanted to have kind of an ESG portfolio. And the net effect, because they didn't have a lot of funds, was that when I looked at it, I said you know I think forget intra asset class diversification for this small 401-k portfolio just put it all in that ESG index fund and fill out the other asset classes with other parts of your portfolio, with your husband's IRA and so forth.

So this is especially true, you can get away with fewer holdings. If you have mutual funds and ETFs, especially if you have broad market index funds and ETFs in your portfolio, the Three Fund Portfolio. Taylor Larimore isn't here but he'll be joining us tomorrow night at the dinner to say hello to everyone. Taylor's Three Fund Portfolio, when you look at it, is just the most elegantly simple creation, where you have diversified U.S equity exposure.

So you're picking up more than 4,000 individual equities in a total stock market index fund. Total International, nearly 8,000 individual equities. In the bond market, holy cow, 17,000 individual bonds. So it's a really well diversified mix. I think that's one reason why many Bogleheads use it as the baseline for their portfolios. Though I would argue people in retirement would probably want to augment these holdings with at least some cash as well, for a year like 2022, so if they need to take withdrawals they can pull from the cash without having to disrupt declining stock and bond holdings.

So conclusions. When we reflect on diversification and how we want to think about it, I do think that diversification is an expression of humility, an expression of saying there are a lot of things I don't know about how this world could unfold and so I'm going to build a portfolio that will help me fare reasonably well in any number of eventualities. So that diversification helps lower volatility, which makes it easier to stick with your plan.

And I think you probably hear that idea of sticking with your plan again and again, but that's the name of the game. The most well-crafted portfolio isn't worth anything if someone can't stick with it. But building and diversification helps lower that volatility. It makes it more likely that you'll stick with your plan.

It's essential across asset classes, across account types, but I think it's especially essential once you move into drawdown mode or as you get close to needing your funds in retirement or whatever goal that you're hoping to fund. It's important that you have assets that you can pull from at those times to ensure that you won't need to pull from depressed asset classes.

And finally it is possible to overdo diversification. I see this all the time. And the main issue with that de-wersification is that it can obscure the big picture with your portfolio. So less is more. As long as you've done the basic blocking and tackling of asset class diversification, intra asset class diversification, account diversification, and timing diversification, that goes a long way to ensure that you have proper diversification. So I'll leave it right there. and we have a break. Thanks.

[Applause]