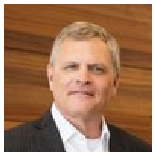
The Downside of Over-Diversifying Your Portfolio



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Nobel prize-winning economist Harry Markowitz published a highly influential paper in the *Journal of Finance* in 1952, which became the basis for modern portfolio theory. This theory, which equates investment risk with volatility – lots of volatility, or wide swings in asset value, means high risk, and vice-versa – gave birth to a concept called the efficient frontier, a tool used in seeking the best possible return for a given level of risk.

Modern portfolio theory (MPT) and the efficient frontier form the foundation for today's common approach of structuring portfolios with lots of diversification to manage risk. As a result, many portfolios include a wide range of investments selected to counterbalance losses with gains. However, overdiversifying your portfolio carries its own risks.

Over-Diversifying Your Portfolio

Portfolios built on modern portfolio theory counterbalance gains with losses. But if financial planners and other advisors take the diversification concept too far – and they often do – their clients end up with portfolios that are extremely complicated, constructed with investments that neither they – nor often their advisors – truly understand. That can defeat the purpose of including them. If you don't understand an investment, you can't really know how it will affect the mix.

The popular wisdom is the advantage of a diversified portfolio is to hold investments that have low or negative correlation to each other – if one goes down, the other is unlikely to do so. This is popularly referred to as having investments that zig when others zag, and this dynamic is widely considered to be an advantage. However, what isn't talked about much is that while losses are muted, so are gains. And owning more assets can mean more buying and selling, which can lead to more commissions and management fees. This is significant because costs are a big factor in net gains.

By contrast, a portfolio with fewer investments is easier and less expensive to manage.

Defining Risk

Amid debates about how much diversification is enough, there's a big question that is seldom asked: How do you define risk? Should you equate risk with volatility and assess it according to how widely a particular investment varies in value? Or is risk better measured by how much you might lose?

It's important to realize that, by plunking down money for investments you know little about, you could actually be increasing risk. Sure, you may have hired an advisor to handle things for you, but would you buy a car an expert recommends without driving it and learning about it first? You would probably want to see how it handles and how well the brakes work.

Financial planning using the MPT lodestar is all about managing risk as determined by volatility, but Warren Buffett doesn't believe risk should be defined this way: "Risk comes from not knowing what you are doing," Buffett says. "Never invest in something you cannot understand."

Volatility

Volatility is simply the price you pay to be in a position to earn returns. Real investing is impossible without exposure to it. If volatility keeps you up at night, stay out of the markets. Instead, put your money in low- or no-yield bank CDs to keep your wealth away from risk from inflation.

To keep clients' portfolios within their risk tolerance, advisors taking the MPT route recommend keeping investments within certain levels of volatility. Yet if investors adhere to this doctrine too slavishly, they increase complexity, management burden and quiet often, costs. And this approach may have little to do with how much these investors can really bear to lose.

No matter what you do, volatility is out there. All investments go up and down in price, so why worry about investments that have a long history of going up in value? Those are the investments you want to choose from. For truly long-term portfolios, there's no need to add all manner of uncorrelated investments like industry wisdom says we should, especially if we don't understand them.

MPT Is Flawed

For many long-term investors, it's better to own fewer investments than MPT might suggest, rejecting standard blends that might go well beyond U.S. stocks and bonds to include emerging market debt, frontier stocks and private global real estate – or worse yet, complex mixes including opaque hedge funds, private equity funds and arcane derivatives.

If you take this logic too far and own too few investments, the resulting concentration of capital in certain assets can expose your portfolio to unacceptable levels of risk. Yet there's a strong argument for keeping long-term portfolios simpler and more manageable.

That's what Warren Buffett does. Though few people have even a scintilla of Buffett's investing knowledge, they can find their way by breaking down unfamiliar investments into their component parts and getting a grip on their basic dynamics. If you can't do this, you can still earn good returns by limiting your portfolio to investments you already understand.

(For more from this author, see: *New Tax Laws Make Muni Bonds Appealing*.)