The Stan Clark Financial Team's

PERSPECTIVES

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Investing

Diversify – but don't di-worse-ify

By Michael Chu, Investment Advisor

Diversification is one of our key investment principles at the Stan Clark Financial Team. It's a principle that is simple yet effective: Spreading out your investments reduces your overall risk. To build a resilient portfolio, we diversify in several different ways, including investment style, the number of positions, industry and geography.

There is, however, such a thing as too much diversification, or what we call di-*worse*-ification. If you just spread everything out, you might have less risk. But you'd also be diluting the best opportunities. You'd be reducing risk at the cost of better expected returns.

The good news is: There are smarter ways of diversifying that can reduce risk without sacrificing returns.

First, let's look at the potential downside of diversification with mutual funds, which usually have a mandate to invest in a certain style. Let's take large-dividend-paying companies as an example. Typically, the fund manager will have a list of stocks they like best. Maybe this list consists of 10 or 20 stocks. But to prevent wild swings in performance, each mutual fund tries to diversify on its own. That requires a lot more than 10 to 20 stocks, probably 40 to 50 stocks. In fact, many mutual funds own more than 100 stocks.

Now, in order to buy 100 stocks, the manager has to go further down the list of stocks they like. They may go down far enough that they end up investing in less-liked stocks. So, while the mutual fund is diversified, the expected returns can be lower. The reason is that, by then, the managers are invested in an average portfolio made up of some good companies, but also a lot of mediocre companies. This is a classic example of di-*worse*-ification.

Another common problem of over-diversifying is that investors typically have more than one mutual fund. They try to diversify by holding different funds. This makes sense at first. But when we dig further, we find it has some negative consequences. You can still have the issue we discussed earlier: a diluted portfolio. But things get worse. Among all the mutual funds, you would end up owning several hundred stocks. This is clearly over-diversification. Also, different funds might not work well together because the managers don't talk to each other.

It's all reminiscent of the old saying about too many cooks spoiling the broth. It's a duplication of efforts on some parts along with other efforts that cancel each other out. For example, one manager might shun resource stocks while another might favour them.

Our approach is different. We use a method of diversifying that reduces your risk without sacrificing your expected return. First, we use multiple strategies to manage your portfolio. The rationale is like having multiple fund managers. With our approach, each of our strategies doesn't need to be diversified individually. That means we are able to invest in the top-ranked stocks in each strategy. Since we use 10 strategies, when we add everything up we get a portfolio that overall is diversified.

Let's get even more granular about our approach. Say we buy the top-five-ranked stocks in each strategy and multiply this by the 10 strategies. We'll end up with a well-diversified portfolio of 50 stocks. That's a key difference. Because we use a multi-strategy approach, we stay in the stocks we like, and still have a diversified portfolio to spread out the risks. That's why we don't have to sacrifice returns to reduce risk.

Our individual strategies are also different from each other because they are based on different styles. This improves our ability to spread out risks. Properly diversifying is more than just adding more positions.

The other benefit of our approach is that we coordinate between the strategies. Our strategies are designed to work together, so there's no duplication or opposing efforts.

There's more to say about our strategies. We'll continue the discussion in future articles. ■

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