

# The Three Dimensions of Diversification

By William Hammer, Jr.



William Hammer, Jr.

*“Have Enough Eggs to Make an Omelette.”*

**D**iversification is the “daily exercise” of investing. We all need it and it demands discipline to do it day after day, month after month, year after year.

Harry Markowitz, who has one more Nobel Prize in Economics than you or I do, called diversification one of the economic world’s rare “free lunches.” His life’s work shows that diversification can increase return for a given level of risk, and it can lower risk for a given level of return.

The beauty of diversification is that it remains one of the few promises that we can make to our clients. We cannot prevent the next bear market, but we do have the power to promise that our clients’ portfolios are always diversified. Diversification is also the great socioeconomic equalizer because no investor is too big to ignore it or too small to benefit from it.

While our main focus in designing an investment plan is to match the portfolio asset mix with an agreed-upon set of goals, we may not necessarily achieve diversification. Proper diversification involves three crucial dimensions—breadth, depth, and time—that we can master by answering three simple questions.

## **Breadth—Are you diversified across asset classes?**

Committing to a wider range of assets within each category allows for a smoother ride without hurting results. For equity investments, we balance domestic, developed international, and emerging markets. We can further narrow each of those into large-cap, small-cap, value, core, or growth. Fixed income spans corporate, municipal, and government bonds of varying maturities and can also include international bonds.

We can further lower risk by giving each area enough weight to matter, but not enough to matter too much. For example, the financial media has promoted the view that the decade ending in 2009 was a “lost decade” for stocks because the S&P 500 was essentially flat. But this notion tells only a very small part of the story since domestic small cap value, international small cap value, and emerging markets all produced double-digit annual returns during

that period. A broadly diversified equity portfolio would not have suffered from a lost decade.

## **Depth—Are you diversified within each asset class?**

To lower risk even further, each carefully chosen asset class should contain a large number of holdings. The larger the number of individual stocks or bonds in each basket, the lower the impact that any one disastrous holding could have on the overall portfolio and financial plan. The cheapest and simplest way to gain this kind of deep exposure is through ETFs, mutual funds or separately managed accounts.

## **Time—Are multiple time horizons balanced properly?**

No matter a client’s wealth or season of life, diversification also involves managing “buckets” of money to support current, intermediate, and long-term financial needs. Intimately understanding our clients’ goals, values, and personalities helps us to determine how and how much to invest in each of these buckets. A mediocre professional blames a client when he needs to sell holdings to generate cash. A first-class professional anticipates this need and has cash available to be sent out that day.

Besides being useful in the analysis of a portfolio, these three questions can also apply when looking at a client’s overall balance sheet. Our holistic planning may reveal that a client has much of his or her net worth concentrated in one asset such as a private business, real estate, or an individual stock. In many cases, this asset was the major contributor to our client’s success and we must honor that. However, we must also remind clients that the same strategies that made them wealthy may not keep them wealthy. **Concentration builds wealth, but diversification protects it.**

At the simplest level, **true diversification means carefully choosing a variety of baskets, putting a lot of eggs into each basket, and making sure that there are enough eggs available when a client needs to make an omelette.**

**FA**

*William Hammer, Jr. is the vice president for wealth management at Vanderbilt Partners, Melville, LI. He can be reached at 631-845-5100 x3810.*

This communication does not constitute investment advice and is for informational purposes only, is not intended to meet the objectives or suitability requirements of any specific individual or account and should not be construed as solicitation or a recommendation by Vanderbilt or its affiliates to buy or sell any securities or investments. An investor should assess his/her own investment needs based on his/her own financial circumstances and investment objectives.

Vanderbilt Partners is a division of Vanderbilt Securities, LLC.  
Securities offered through Vanderbilt Securities, LLC; a registered broker-dealer member FINRA/SIPC. Registered with MSRB.