YORKBRIDGE
WEALTH PARTNERS

February 2022

“Why Diversification Matters”

One of the keys to successful long term investing is learning how to balance the need for growth to outpace inflation with the desire for security.   Through a diversified investment approach, one can mitigate risk and volatility, potentially reducing the number and severity of drawdowns within a portfolio.

Broad Diversification involves the spreading of a portfolio among disparate equity styles, sectors and geographic areas, which have historically run on different cycles. The obvious examples: growth tends to cycle in contrast to value, large cap to small cap, and international to domestic U.S. In principle, this makes perfect sense, but in practice, it can be a challenge to remember.

The fundamental concepts are:

- Broad diversification amount different equity sectors and styles implies one critically important truth: we will never own enough of any one idea to make a killing in it, *but* we will never own enough of any one idea to get killed *by it* either.
- With broad diversification, we are trying to suppress to some extent the short to intermediate term volatility of the overall portfolio, because the different components will be running on different cycles, while still earning the full returns of all components *in the long run.*
- In efficient markets, anything we do to mute volatility in the shorter term is also going to suppress shorter-term return. We must remember the long term goal; the full return of all the portfolio components over the long term.
- Note that in a well or intelligently diversified equity portfolio, there will be times when some component (or multiple components) will be “underperforming”. That is how we know it’s really diversified.
- The last thing we would do is sell the component that is down to chase the one that’s already up the most. That would turn the portfolio into a bet on one trend, which is just speculation and not investing.
- Throughout the year, or at least once a year, we rebalance your portfolio to return to the optimal amounts or quotas. When this is done, we will harvest some of the gains in the components that have gotten expensive or grown the most and reinvest them in whatever is relatively cheap.
- As shown in the below chart, most people do the exact opposite of this notion, which is one reason why from 2001 to 2020, the average investor had a return of 2.90% when a diversified portfolio of 60% stocks and 40% bonds had a return of 6.40%.

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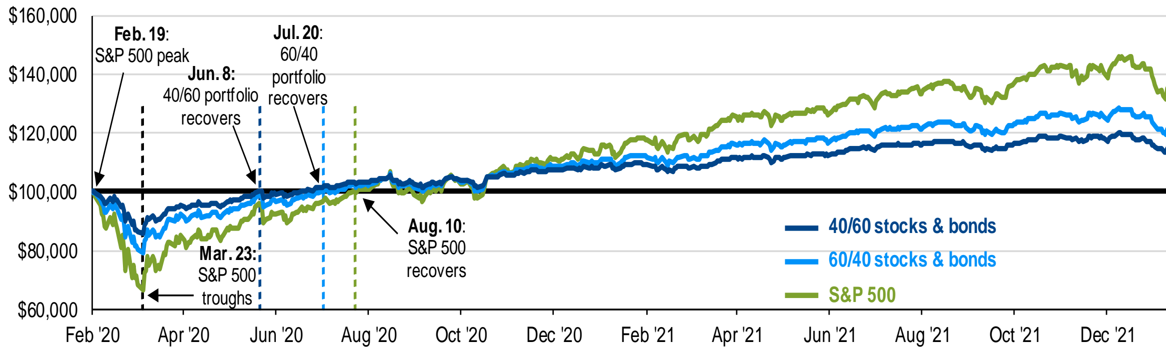
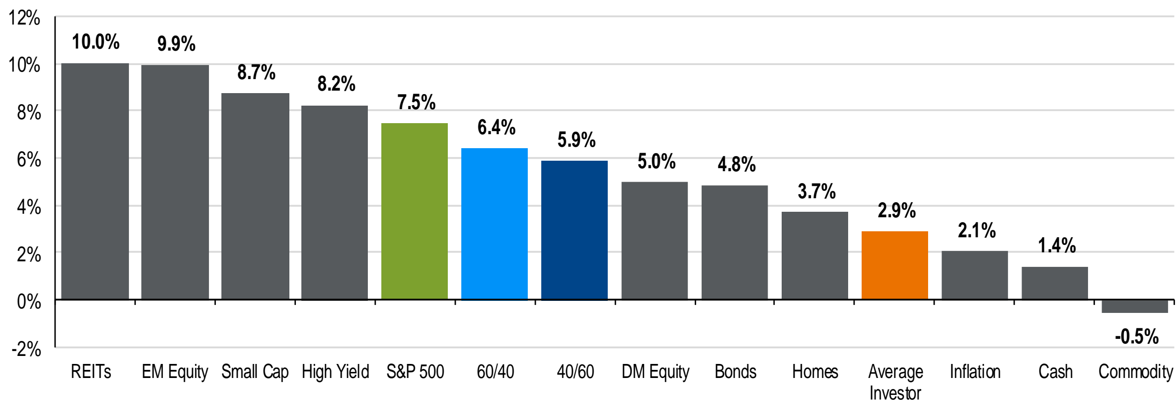
Diversification and the average investor

Portfolio returns: Equities vs. equity and fixed income blend



20-year annualized returns by asset class (2001 – 2020)



Source: Bloomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) Dalbar Inc, MSCI, NAREIT, Russell.
Indices used are as follows: REITs: NAREIT Equity REIT Index, Small Cap: Russell 2000, EM Equity: MSCI EM, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Bonds: Bloomberg U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Cash: Bloomberg 1-3m Treasury, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.
Guide to the Markets – U.S. Data are as of January 31, 2022.