

The 1-2-3 of Investing

Part 2: Diversification

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Synonyms for the verb “diversify” help to convey its meaning. Words such as “vary,” “broaden,” “transform,” and “assort” make clear the need for investors to spread their money across different asset classes, industries, and geographic regions in order to minimize the risk of holding stocks. The promise of diversification is that a downturn in one area of the economy does not harm overall returns—akin to not putting all your eggs in one basket.

Identifying which stocks meet those qualifications can be achieved by calculating a statistic called correlation coefficient. It is a measure that spans from +1 to -1. Stocks in the same industry will typically have correlations in the +0.5 to +1.0 range. Of course, diversification implies that investors prefer stocks that share correlations with other equities closer to -1. Since solving for correlations requires the calculations of other statistics (covariance and standard deviation) as well, investors are advised to leave the job to professionals.

Another dimension of diversification is the number of stocks in an investor’s portfolio. While there is no single correct number, general guidelines suggest 20 to 30 stocks. Having a sufficient number of equities transforms total risk into systematic risk—or movement limited to the movement of the overall market. Fluctuations connected with an individual stock are referred to as unsystematic risk.

Until we talk about other types of securities, our focus now is on diversifying strictly with stocks. For investors with a good understanding of the stock market who are ready to assume

greater risk, diversification can be achieved by simply combining shares of stock. For those with less knowledge and a small appetite for risk, mutual funds are key.

It was not until the 1980s that mutual funds captured the attention of American investors. The earliest funds can be traced to Massachusetts in the 1920s. While mutual funds are seen as a safe harbor for investors, they are not exempt from market downturns. The bear market of 1969 cooled the public's fascination with mutual funds for some time. The bull market in the 1980s and 1990s soon restored the love. (Since a bear's paws swipe downward and a bull's horns point upward, bears and bulls represent down and up markets, respectively.)

Currently, there are more than 10,000 individual mutual funds that are offered in the United States by roughly 500 fund sponsors. Interestingly, the future of mutual funds may not be as bright as their growth suggests. Mutual funds can point to baby boomers (those born between 1946 and 1964) for their rise in popularity; however, the imminent retirements of boomers will see them withdrawal of funds as they seek to decumulate.

Anticipating that change, mutual fund operators are creating new products for investors. One such innovation is the exchange-traded fund. ETFs trade on an organized market such as the New York Stock Exchange. Most are passively managed and linked to a market index like the Standard and Poor 500. The absence of constant monitoring keeps the cost low. Your trusty FLIP contributor Dr. Kochman owns an ETF and can vouch for its benefits.