The Importance of Achieving Diversification—and an Easy Way to Do It

Key Points

- Savvy investors understand that diversification is key to helping reduce investment risk and preserve growth potential.
- One way to achieve it easily is with Schwab's Mutual Fund Portfolio Builder, which provides investors access to diversified pre-defined portfolios of mutual funds from the Select List.
- Schwab's recent lowering of minimums for funds available in MF OneSource means that Mutual Fund Portfolio Builder is now accessible to even more investors, with a minimum as low as $5,000.

In our last issue of the *Mutual Fund OneSource Select List*, we wrote about Schwab lowering the minimums for the majority of funds participating in our Mutual Fund OneSource service, and how one of the benefits of that change was the associated reduced minimums required for participation in Schwab's Automatic Investment Program (AIP)

Another attractive benefit of the lower minimums relates to Schwab's Mutual Fund Portfolio Builder, an online tool that provides investors access to diversified, pre-defined portfolios of mutual funds drawn from the Select List. Whereas the previous required minimums to get started in this program were $10,000 for taxable accounts and $12,500 for IRAs, the minimum for either account type is now just $5,000. This makes it even easier for investors to get started with a diversified portfolio of mutual funds.

The Premise of Diversification

Diversification is one of the most important concepts investors should grasp, yet many are unclear on its aim. The goal of diversification is not to boost performance—it won't ensure gains or guarantee against losses. It's to help compensate for poorly performing assets by holding others that are performing well—or at least holding up better.

Diversification actually begins with asset allocation: how a portfolio is divided among stocks, bonds, cash, and other investments. An investor's asset allocation is determined by how much risk he or she is willing to take, as well as his or her financial situation and investment horizon. Diversification takes it a step further by seeking a broad range of investment types within each asset class. First introduced in the 1950s as what's known as "Modern Portfolio Theory," it posits that rather than judging risk by looking at an individual investment, one should look at how *all* the investments within a portfolio work together. By choosing a variety of investments across a wide range of sectors, industries, companies, and geographic locales that ideally react differently to any given market conditions, therefore, investors should be able to reduce their overall risk.

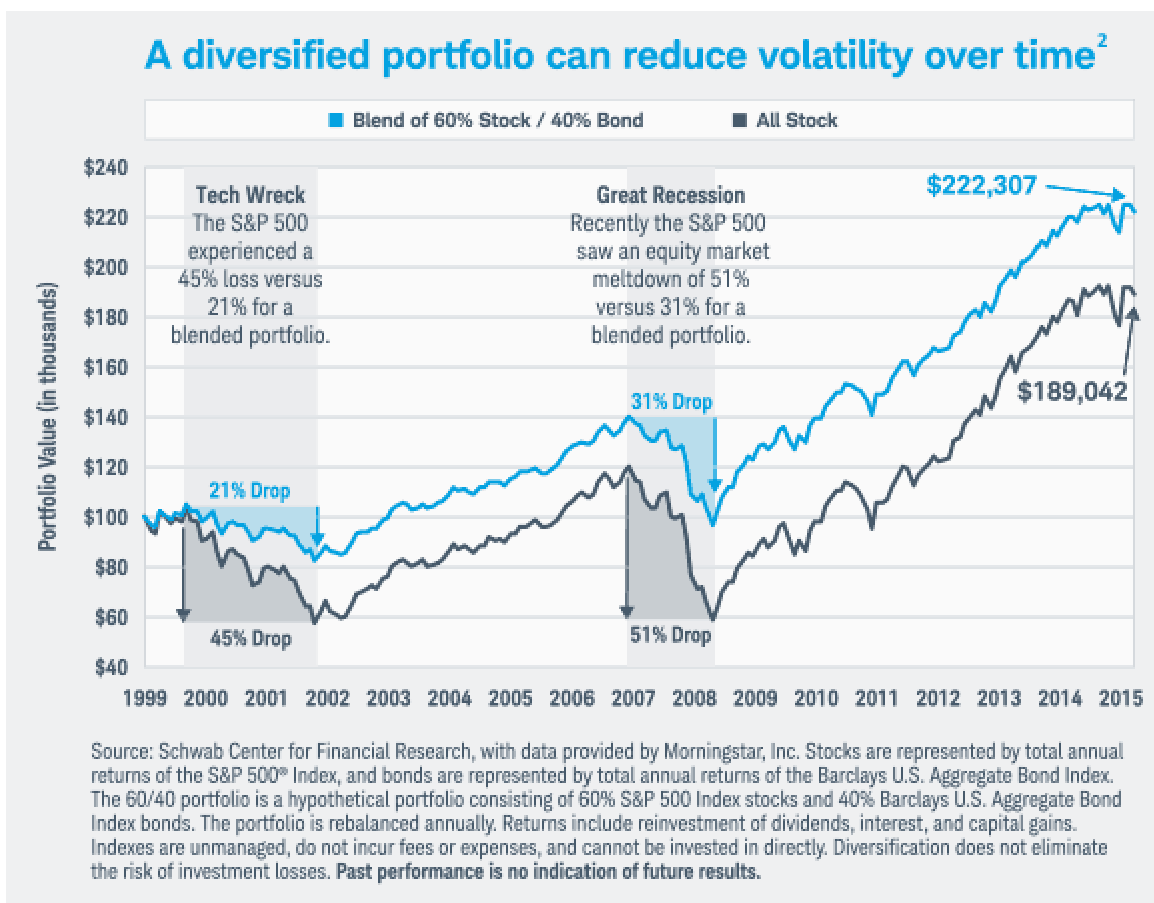
Among stocks, for example, one can invest in large-cap U.S., small-cap U.S., or international stocks. Within each of those categories, however, are companies operating in different industries and sectors, of varying sizes, and in different parts of the world. The ultimate goal of diversification is to hold investments that won't necessarily move in lock-step with one another so that when one or more are hard-hit, others are holding up relatively well.

The Value of Diversification Illustrated

During the 2007–2008 financial crisis and subsequent bear market, when investments across many different asset classes lost value, many investors may have felt that diversification was irrelevant. Painful as that time might have been, diversification did indeed help contain portfolio losses.

Consider the performance of two hypothetical portfolios: one comprising a blend of 60% stocks and 40% bonds; the other 100% in stocks. Whereas both lost ground during the "great recession" from October 2007 to February 2009, the diversified portfolio lost less—it was down 31% versus the all-stock portfolio's decline of 51%.[1] While this may not seem reassuring to some, it is evidence that diversification did its job, helping limit losses during the worst of times but not avoiding them entirely.

The graph below shows the performance of those two portfolios during that period, as well as for a longer period—from 1999 through 2015—that included both up and down markets. Although as of the end of that longer period, the value of the all-stock portfolio was greater than the diversified one, the graph shows how the diversified portfolio lost less than the all-stock portfolio during down cycles in the market yet still captured significant gains during up cycles.



Source: Schwab Center for Financial Research, with data provided by Morningstar, Inc. Stocks are represented by total annual returns of the S&P 500® Index, and bonds are represented by total annual returns of the Barclays U.S. Aggregate Bond Index. The 60/40 portfolio is a hypothetical portfolio consisting of 60% S&P 500 Index stocks and 40% Barclays U.S. Aggregate Bond Index bonds. The portfolio is rebalanced annually. Returns include reinvestment of dividends, interest, and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Diversification does not eliminate the risk of investment losses. **Past performance is no indication of future results.**

One important development investors should be aware of is that since the financial crisis, it has become more difficult to achieve diversification, because many formerly uncorrelated asset classes are now moving more in tandem. Whereas, for instance, international stocks once behaved considerably differently in various market and economic environments than did U.S. stocks, they are now more correlated, the result of the growing interconnectedness of global financial markets.[3] That means it might take a bit more digging to uncover potential portfolio holdings whose price movements aren't so closely tied to one another.

And while most mutual funds are diversified by their nature in that they hold many securities, all funds do not provide the same amount of portfolio diversification. Those that focus on a small sector of the market, such as a particular industry or country, may not add much diversification to a portfolio because all of the fund's holdings may be very highly correlated, moving in lock-step with any given impact or environment. Conversely, there's actually such a thing as *overdiversification*—more holdings than are necessary that do not further reduce portfolio risk. In other words, there's a point after which further diversification adds no benefit. So it's not simply the *number* of funds you own, but how differently each reacts to varying market impacts.

Getting There

For some people, the prospect of discovery is an exhilarating one, and they revel in the research required to uncover the optimal holding to address each piece of their investment pie. But for many others, that prospect is daunting. It's not hard to understand why. Assembling and monitoring a diversified portfolio requires time and a solid understanding of global markets, particularly as the world becomes more interconnected. For those who would welcome some assistance, there's the Schwab Mutual Fund Portfolio Builder.™

Designed for self-directed investors, the Mutual Fund Portfolio Builder helps investors identify a mutual fund portfolio that might be appropriate for them, appreciably simplifying the research process. After choosing one of five risk profiles— Conservative, Moderately Conservative, Moderate, Moderately Aggressive or Aggressive—an investor is presented with a diversified portfolio comprised of highly rated mutual funds, drawn from the Mutual Fund OneSource Select List.

To help investors choose an appropriate risk profile, five asset allocation models are provided, along with time horizons and investment goals appropriate for each, average annual returns over the past 45 years, and each portfolio's best-year and worst-year return over that period. And if an investor prefers help, a risk profile questionnaire is also available.

The Mutual Fund Portfolio Builder is an educational tool designed to help investors establish a one-time, diversified portfolio of funds. It allocates a lump sum investment and generates the buy orders for the identified funds. Investors retain control over all decisions made, including ongoing portfolio monitoring and rebalancing of fund allocations as needed and appropriate. There are no fees for the service.

While the Mutual Fund Portfolio Builder tool is ideal for beginning investors or those who don't have a lot to invest, it's also appropriate for experienced investors or those with more to invest who may not have sufficient time or interest to dedicate to portfolio-building.

The Bottom Line

Risk is inherent in investing; no matter how diversified your portfolio is, risk can never be eliminated entirely. By diversifying one's holdings in an investment portfolio, the risk of specific holdings can be reduced. But inherent market risks—or "systematic risk," such as that in evidence during the financial crisis—can affect nearly every individual holding, and no amount of diversification can prevent it.

With that said, diversification proves its mettle over long time horizons that comprise both up and down markets. For those seeking a truly diversified portfolio, built with high-quality mutual funds across a range of asset classes, Schwab's Mutual Fund Portfolio Builder may be just the tool to get you there.

To learn more about Schwab's Mutual Fund Portfolio Builder

- Online
- By phone: **800-435-4000**

1. The stocks in the hypothetical portfolios referenced are represented by the S&P 500 Index, a market-capitalization weighted index that consists of 500 widely traded stocks chosen for market size, liquidity, and industry group representation.; bonds are represented by the Barclay's U.S. Aggregate Bond Index, a market-value-weighted index of taxable investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage backed securities, with maturities of one year or more.

2. The stocks in the hypothetical portfolios referenced are represented by the S&P 500 Index, a market-capitalization weighted index that consists of 500 widely traded stocks chosen for market size, liquidity, and industry group representation.; bonds are represented by the Barclay's U.S. Aggregate Bond Index, a market-value-weighted index of taxable investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage backed securities, with maturities of one year or more.

3 Source: Charles Schwab Investment Advisory, Inc., with data from Morningstar Direct.

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Past performance is no guarantee of future results.

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