

Insights

Optimising Diversification

Most investors know that diversification is essential to their portfolio. But what is diversification? Diversification is often described as not placing all of your eggs in one basket. However, this is only part of the story because, ideally, the portfolio should include more than just a wide range of different types of investments. It should include a range of investments that perform differently from each other and have expected returns that are not closely associated with the others.

Working with the right advisors, investors should strive for a portfolio that is not just diversified but optimally diversified. Achieving this can make all the difference in terms of the portfolio's overall return and, especially, volatility.

The Basics

As John Templeton famously noted in 1983, "The only investors who shouldn't diversify are right 100% of the time." A diversified portfolio does not concentrate in one or two investment categories or asset classes. Rather, it consists of a range of investments and if one type of investment experiences negative returns, chances are good that another category of investments might be increasing in value at the same time. Significant academic research has shown that a well-diversified portfolio reduces risk for a given rate of return. While most investors understand the importance of diversifying, many do not realise that there is what we call, in simple terms, "good diversification" and "bad diversification." Good diversification can be achieved by analysing and selecting investments, based on expectations for how they will perform in conjunction.

Good Diversification

Just having a portfolio with a variety of investments is not enough. There are decisions related to diversification that can help optimise a portfolio. Investment professionals use a statistical measure known as "correlation" — which is based on monthly returns — to determine the best combination of investments to include in a specific portfolio. Correlation works fairly simply by measuring the degree to which the various assets in a portfolio have performed in a similar fashion in the past.

Positive Correlation

When you have two investment products that have a tendency to perform in a similar fashion, this is termed "positive correlation." This is the tendency for two investments to move up or down together on a monthly basis. Holding both assets can still add value to a portfolio, but the higher the level of positive correlation, the less diversification benefit is realised from a correlation point of view. The maximum positive correlation possible is a value of +1.0, which would occur if two assets are perfectly correlated and this would provide no benefit to the portfolio from a correlation point of view.

Negative Correlation

When you have two products that tend to perform differently, these are considered complementary products and this is termed "negative correlation." This is the tendency for two investments to move opposite to each other on a monthly basis. Holding negatively correlated assets tends to reduce volatility in a portfolio and the higher the level of negative correlation, the more diversification benefit is realised. The maximum negative correlation possible is a value of -1.0, which would occur if two assets are perfectly negatively correlated.

In Summary

For optimal diversification, investors should put two investments together that have a +0.35 or lower cross-correlation. The expected result is to decrease volatility while keeping (or decreasing only slightly) the anticipated return. Consciously seeking out investments with a low positive correlation to each other can go a long way towards optimising a portfolio's overall diversification.

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