The 10 Essential Elements of Investing

Essential Element 3
Diversify

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

Written: February 1, 2019
Updated: April 30, 2020

Diversifying helps institutions manage risk by not putting all their investment eggs in one basket. While there is a rational case to diversify (to achieve a higher return for the same risk), there is also a stronger behavioural case to diversify (to reduce the risk of behaving badly as investors). Most investors, including experts, have no skill in predicting the direction of financial markets. Diversifying means buying a range of assets, accepting that some will rise while others will fall, as part of what we reasonably expect to be a long-term positive trend but whose path we cannot predict over the short term. While a diversified portfolio is unlikely to be a big winner in any given year, it is also unlikely to be a big loser. This steady approach helps institutions stay in the market and build capital over the long term, without having to be too cautious or confident. We will cover four types of diversification:

- Asset mix (blend of stocks, bonds and cash in the portfolio).
- Asset selection (types of stocks and bonds).
- Foreign currency (exposure to foreign currencies in US and international stocks).
- Investment strategy (methods used to select securities).

Asset mix

When we refer to asset mix, we mean the blend of stocks, bonds and cash in the portfolio. For small and medium foundations and charities, this largely means stocks and bonds. Stocks are for growth, while bonds are for safety. Institutions do not hold all their investments in stocks because stocks as claims on the profits of a business are too risky (even an entire stock market can lose 50% or more in a matter of months). At the same time, they do not hold all their investments in bonds because bonds as loans to governments or corporations provide income but are not expected to provide capital growth. To balance the competing objectives of growth and safety, long-term investors typically hold a portfolio of 50-70% stocks and 30-50% bonds. In our view, an appropriate allocation to cash in a long-term portfolio is minimal. The main reason to hold cash is to cover spending for the current year and possibly the next year. This amount can be held separately from the portfolio, so that the only cash in the portfolio is from dividends and interest. By using cash for short-term liquidity, institutions can focus their long-term investment planning on setting an appropriate mix of stocks and bonds. Below we reiterate some of the points made in Essential Element 2: Set the mix, regarding the important role played by stocks in maintaining long-term purchasing power over bonds and bills (Treasury bills, equivalent to cash).

Table 1: Percentage of time stocks outperform bonds and bills over various holding periods, United States, 1871 to 2012

Holding period	Stocks outperform bonds	Stocks outperform bills
1 year	61.3%	66.9%
5 years	69.0%	74.6%
10 years	78.2%	83.8%
20 years	95.8%	99.3%
30 years	99.3%	100%

The above table is from Jeremy Siegel, *Stocks for the Long Run*.[1] Siegel explains how stocks are safer than they appear over the long term:

> Stocks are unquestionably riskier than bonds or Treasury bills over one- and two-year periods. However, in every five-year period since 1802, the worst performance in stocks, at -11.9 percent per year, has been only slightly worse than the worst performance in bonds and bills. And for 10-year holding periods, the worst stock performance has actually been *better* than that for bonds or bills.[2]

Institutions that are truly investing for the long term will have a bias towards stocks, which are more likely to exhibit higher returns than bonds or cash and have a higher chance of preserving purchasing power over the long term. When matched to a long-term horizon, stocks can be less risky than bonds or cash.

Table 2: Asset classes, annualized returns, United States, 1802 to 2012, US dollars

Asset class	Nominal return	Real return	Final balance
Stocks	8.1%	6.6%	$704,997
Bonds	5.1%	3.6%	$1,778
Bills	4.2%	2.7%	$281
Gold	2.1%	0.7%	$4.52
US dollar	1.4%	-1.4%	$0.05

The above table shows the result of investing one dollar from 1802 to 2012, in nominal terms (before inflation) and real terms (after inflation).[3] A dollar invested in stocks was worth about $705,000 by 2012, while a dollar invested in Treasury bills was worth just $281. The final balance, in real terms, was over 2,500 times greater for stocks.

Asset selection

When we refer to asset selection, we mean selecting the type of asset (such as US stocks over foreign stocks), not selecting individual securities (such as Apple over Microsoft).

For bonds, broad exposure is important. Since there is limited upside but substantial downside and high cost to trading individual bonds, institutions should have a strong preference for broad market indexes of bonds. Along with breadth of exposure, key factors for bonds are credit risk and rate risk. For a strong and stable bond portfolio, institutions should take no more than a low level of credit risk and a low to moderate level of rate risk. To manage credit risk, bonds should be of high quality (issued by governments and large corporations with investment-grade credit ratings). To manage rate risk, bonds should be a mix of short-term (1-5 years) and medium-term (5-10 years). In the past, a portfolio holding Canadian bonds, comprised of aggregate bonds and short-term bonds, has provided a strong and stable bond position, enabling institutions to take calculated risks with stocks.

The first part of stock selection is about market breadth. Institutions often obtain exposure to a broad range of companies, since individual companies can go bankrupt and wipe out all value for shareholders. For example, in the United States, the S&P 500 index provides exposure to about 500 companies; in the developed markets of Europe, Australasia and the Far East, the MSCI EAFE index provides exposure to about 900 companies; in emerging markets such as Brazil, China and India, the MSCI Emerging Markets index provides exposure to about 900 companies; and in Canada, the S&P TSX Capped Composite index provides exposure to about 250 companies. The broad market indexes mentioned above are mostly comprised of large companies, with some medium companies. Institutions tend to prefer large and medium companies because of their more stable earnings and dividends, although they typically allow some allocation to small companies as part of the stock mix.

The second part of stock selection is about world regions. Long-term investors should consider allocating a healthy amount to US and international stocks, given the small size of the Canadian market. The US stock market is about 50% of the world market, developed markets are about 35% and emerging markets are about 10%, while Canada makes up less than 5%. A "home bias" often prevents investors from obtaining market-like exposure to foreign stocks, which can be prompted by the belief that domestic stocks are more familiar or provide a better matching of expenses in Canadian dollars. This is true to some extent and few institutions would allocate 5% of their stocks to Canada and 95% to the rest of the world. Institutions might consider allocating their stocks in more or less equal parts between the United States, international and Canada. These weights can be tilted within a range, depending on the outlook for each market. Exposure to different regions of the world reduces the risk of being trapped in a low-performing market for an extended period of time, as was the case for buying and holding US stocks in the first decade of the new millennium. The fortunes of different stock markets wax and wane over periods of a decade or longer, in ways that are difficult to predict or recognize at the time. Diversifying helps institutions capture a fair share of market returns, without having to be too cautious or too confident about the future.

The third part of stock selection is about sectors. The Global Industry Classification Standard, developed in 1999 by two major index providers, divides stocks into 11 sectors (further split in 24 industry groups, 69 industries and 158 sub-industries). Stocks within a sector are likely to be more similar to their peers than to stocks in other sectors. Sectors have different sensitivities to the business cycle. Health care, consumer staples and utilities are defensive sectors (less affected by a broad market decline), while technology, consumer discretionary and materials are cyclical sectors (more affected by a broad market decline). The remaining sectors are typically described as sensitive, with varying degrees of sensitivity to the business cycle. For Canadian investors, holding only domestic stocks is essentially a bet on energy, materials and financials, which together comprise 70% of the Canadian stock market. Canadian investors need broader geographical exposure in order to obtain broader sector exposure.

Foreign currency

When we refer to foreign currency, we mean exposure to foreign currencies in US and international stocks. Here we refer to stocks, since Canadian investors often hold only domestic bonds. The Canadian dollar, because it is tied to the fortunes of global energy and mining, is pro-cyclical: when the world economy is doing well, the Canadian dollar will do well. In contrast, the US dollar (and some of the currencies of other wealthy nations, such as the Japanese yen and Swiss franc) are anti-cyclical: when the world economy crashes, investors flee to the safety of government bonds denominated in US dollars, Japanese yen and Swiss francs, increasing the value of these currencies. While in 2008, US stocks lost 36.6%, the US dollar surged by 22.2% against the Canadian dollar, significantly offsetting losses for Canadian investors with exposure to the global reserve currency. Diversifying by currency does not involve any complex products like futures or options; it simply consists of selecting the appropriate currency version of a stock fund or holding US securities directly. While over decades, returns are likely to be similar between hedged and non-hedged currency positions in foreign stocks, institutions with regular spending have to pay attention to short-term risks. Having some exposure to foreign currencies through stocks can help Canadian investors reduce the risk of worst-year loss.

Investment strategy

When we refer to investment strategy, we mean the methods used to select securities. We will focus on stocks, since the default approach for bonds is to have broad market exposure. As an example, combining value and momentum can be a useful form of diversification, since these strategies tend to shine at different times. Yet many popular stategies such as growth and momentum are highly correlated (companies with relatively high earnings growth are also likely to have experienced recent gains in share price). Institutions should be aware of illusory forms of diversification. They should also be particularly careful in situations with multiple investment managers. Here good practice is to nominate a lead manager (also called an overlay manager), to monitor the strategies and ensure appropriate diversification across the portfolio.

Conclusion

We have considered four types of diversification: asset mix (blend of stocks, bonds and cash in the portfolio); asset selection (types of stocks and bonds); foreign currency (exposure to foreign currencies in US and international stocks); and investment strategy (methods used to select securities). While asset mix and asset selection are the most important ways to diversify, institutions should also be aware of how foreign currency and investment strategy decisions affect diversification in the portfolio.

[1] Jeremy Siegel, *Stocks for the Long Run* (2014), fifth edition, p. 96, table 6-1.

[2] Jeremy Siegel, p. 94.

[3] Jeremy Siegel, p. 6, figure 1-1.