DOW THEORY FORECASTS

# Don't sleep on diversification

When we talk about growth rates or valuation ratios or dividend yield, people listen. These topics inspire thoughts of strong investment returns and the excitement of selecting stocks. If you subscribe to this newsletter, you probably find these topics appealing.

Of course, when the subject of diversification comes up, we can hear the snores from Seattle to Miami. If growth and valuation are steak and potatoes and yield is ice cream, diversification plays the role of lima beans. We all know they're good for us, but we'd rather not think about them.

Don't make the mistake of dismissing diversification. Any investor can diversify a portfolio. It doesn't take a degree in finance, and the risk-reduction benefits are substantial. The chart below illustrates a simple exercise in diversification. A portfolio comprised of two sector indexes (industrials and energy) provides a return about midway between the individual indexes' returns, but with less volatility and a higher ratio of return per unit of risk.

Diversification is not a silver bullet. Market risk — caused by such forces as inflation, interest rates, and political change — cannot be diversified away. Simply wading into the financial markets exposes you to such risk. However, much of the risk of your stock portfolio stems from problems faced by companies or industries. That's where diversification comes in.

The financial crisis of 2007 and 2008 crushed banks and other finance companies, while the decline in oil prices from mid-2014 through early 2016 wreaked havoc on the energy sector. Such disasters are going to occur. Most of us can neither predict nor fully avoid them. Instead, we try to weather the storm by owning a diversified portfolio. If the next year turns out disastrous for health-care stocks, our stocks in that sector will probably underperform. But perhaps our technology and industrial holdings will pick up the slack.

## Four ways to diversify

Diversification cuts portfolio risk not by reducing the volatility of individual securities, but by allowing the inherent differences between those securities to mitigate their individual risks. When one stock suffers, others may perform just fine. And in a down market, not every stock or sector will take the same hit. Here are some ways to diversify your equity portfolio:

• **Fixed income.** The percentage of your portfolio you should keep in fixed income (bonds, preferred stocks, bond funds, etc.) varies based on factors including your age, wealth, risk tolerance, and when you need to access the money.

• **Sector or industry.** Sectors don't move in lockstep, though some have more in common than others. Over the last 20 years, the S&P 1500's industrial and consumer-discretionary indexes were 87% correlated, which means the indexes tended to move in the same direction 87% of the time. Such high correlation suggests stocks in those two sectors tend to respond similarly to outside forces. However, the correlation between industrials and energy stocks is 62%, and the correlation between industrials and utilities is just 50%. Our Buy List and Long-Term Buy List are fairly well diversified, the Focus List is less so.

• **Size.** While small stocks and large stocks don't usually move in different directions, their returns can differ in magnitude. For most investors, keeping 20% to 50% of your equity holdings in small-cap or midcap stocks makes sense.

• **Foreign exposure.** We don't recommend many non-U.S. stocks. However, because U.S. and foreign stocks often follow different trends, holding 10% to 25% of your equity portfolio in foreign stocks may be prudent.