Does Investment Diversification Still Matter?

By Thomas L. Walsh Jr.

Diversification, in the context of portfolio management, is an attempt to reduce the uncertainty (volatility or risk) of portfolio returns while optimizing those returns based on an acceptable level of risk. In a year like 2022, where stocks and bonds experienced negative returns broadly, diversification comes under greater scrutiny. Portfolio diversification is best defined by Harry Markowitz's work in 1952 when he developed Modern Portfolio Theory which suggests that a diversified portfolio of lowly-correlated assets would produce an optimal "risk-adjusted" outcome. The question remains: did diversification fail us in 2022?

Historically, while rare, it's not inconceivable for both stocks and bonds to lose more than 10% in the same year. The failure of a quantitative approach to portfolio construction is that it tends to over-simplify diversification. Such an approach often manifests as model portfolios that seek to "fill buckets" of various asset classes with various risk profiles. To achieve truly meaningful and effective diversification, one must consider a portfolio's objectives relative to its outcomes.

Diversification is then achieved as asset classes are selected based on the investor's goals and serve as resources for specific purposes – from liquidity and preservation to long-term growth and legacy goals. With an investor's goals as the primary driver in the portfolio construction process, uncertainty in portfolio outcomes can be greatly reduced over a long enough time horizon. Having the flexibility to invest in any asset class without the compulsion to be invested in everything, such as model portfolios mandate, provides investors with an optimal diversification strategy.

Model portfolios and risk tolerance "buckets" are the antithesis of a smart diversification strategy and often lead to wide variability in portfolio outcomes from their intended goals. The negative returns and positive correlations of assets in 2022 exposed the tail-risks of model-driven portfolios created by many financial institutions. These portfolios were promoted as well-diversified, implying safety, but neglected individual investor goals and objectives. The current over-diversification of investment portfolios is a result of several factors: gross misapplication of Modern Portfolio Theory, investor fear following the 2007-2008 Financial Crisis, and an ever-growing population of exchange traded funds and mutual funds. Model portfolios have become a basket of risk assets encompassing every asset and sub-asset class imaginable, often with over-lapping securities held across several funds and managers. This leaves investors with little more than broad market beta and exposes them to unmitigated systematic risk.

The misapplication of Modern Portfolio Theory has led to disappointing results for investors when portfolio outcomes are vastly different than projected results of model allocations. This becomes most noticeable in periods of extreme downturns when asset correlations migrate toward being positively correlated. In other words, all assets decline in unison due to mass "risk-off" selling pressure.

Constructing high-quality, high-conviction portfolios that combine market inputs and expectations with an individual's unique goals and objectives increases the likelihood of successful outcomes regardless of market conditions. Also known as goals-based investing, this approach takes a bottom's up view of diversification and asset allocation by only including asset classes that align with an investor's stated goals. This is done through matching cash flows with need, aligning bond maturities with known liabilities, or selectively adding assets that reduce volatility or enhance returns within the investor's stated objectives.

Our philosophy recognizes that the real harm of over-diversification is when portfolio construction is driven by a generic goal of "filling buckets" and "gaining exposure." We believe that diversification is beneficial but should be viewed as a "means" and not an "end," and ultimately should be driven by highly personalized client objectives.

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