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Why Is Diversification a Good Thing?

This newsletter is intended for those whose least favorite topic is "***asset allocation***" and whose eyes glaze over when your spouse or financial advisor starts to talk about "***diversification.***" Oh yes, let's not forget ***"rebalancing."*** And you know what? Maybe all the "smart folks" that think they know all this could benefit as well from a quick read.

<u>Diversification is:</u>

Planting several tomato plants in the hopes the gophers don't eat them all. Betting on two or three horses to increase the odds of one placing in the race. Having more than one child to improve the likelihood that one of them turns out successful and can support you if you run out of money.

Simply put, diversification is not putting all your money into one type of investment. A diversified portfolio includes some combination of:

- Stocks which represent ownership of a company. You profit when the company share price goes up and you sell the shares or if they pay you a dividend.
- Bonds which represent a loan to a company in return for interest. Prices do change prior to maturity but they are "usually" less volatile than stocks.
- Stocks from different investment "styles" as well as big vs small companies.
  - ◊ "Growth" companies focus on growing profits and reinvesting money in new products, plants and employees. They usually don't pay dividends.
  - ◊ "Value" companies are in more mature industries. These companies have established products and markets and often pay dividends.
- Stocks from different market sectors such as technology, energy, consumer products, or financial services.

- Stocks and / or bonds from different geographic regions: US vs established foreign economies like Europe, Canada, Japan or Britain vs "emerging" foreign markets like India, Vietnam, Brazil, or Africa.
- Bonds are a loan to a public company. Bonds have different maturities from short-term (1 to 5 years) to longer terms up to thirty years. Shorter-term bonds pay a lower yield and are less volatile than the longer-term bonds with higher interest rates and with greater volatility in the price.
- Bonds from companies with a higher credit rating (pay a lower interest rate) or companies with a lower credit rating (you guessed it, pay higher interest). Higher credit ratings have less volatility and lower credit rating are more volatile.

Each item above historically performs well in different economic and market cycles… Winners Rotate. Some are up while others are down. Over time, historically they all make money (but nothing is ever guaranteed and past performance is neither a guarantee nor an indication of future performance..bla., bla, bla). If you need details, I would welcome a longer conversation.

A truly diversified portfolio will almost always have some investments not doing well over the most recent time frame. In 2018, most stocks declined, with foreign stocks declining more than US stocks. In 2017 the story was very different as both US and foreign stocks did quite well. Please call if you would like to discuss details.
The theory is that while diversification should suppress some of the short- or mid-term volatility in your portfolio, the plan is to fully harvest the full-return of each component over the longer-term.

Asset allocation is the process of deciding how much of each item (US stocks vs foreign vs bonds vs what kind of bonds) to put into your portfolio. The answer is driven by your need for your portfolio to make money (this is your financial need) and your other need (emotional) of not going crazy when investments are volatile (as they all are from time to time). *What allocation is best for you? Your answer lies in your financial plan.* ***One size does not fit all.***

Rebalancing is the process of harvesting some of the profit of your recent winners and using the proceeds to buy more of the recent under-performing investments. Think of the concept of "Winners Rotate"….reread the paragraph about different cycles. It is impossible to know what is going to happen in the short-term future. Therefore, after determining your need to make money and balancing that with your volatility tolerance and cash-flow needs, your ***asset allocation*** is determined and ***rebalancing*** occurs on a pre-determined regular schedule.

This can seem to be a complicated and confusing topic and too many advisors try to make it that way in order make you think they are smart…..but it doesn't need to be complicated. As an example, you need to gas up the car, re-fuel as necessary, don't exceed the speed limit, check the tires and change the oil, fluids and brakes as specified by a trained / professional technician. If you do that simple stuff, you will have many long years of safe travel.

What rate of return do you require to accomplish your goals? What is your tolerance for volatility? These are part of your financial plan. The financial plan determines your asset allocation and how your portfolio is diversified. Then just like you service your car, you need to update your financial plan, review portfolio performance, the allocation of investments and rebalance the investments to realign to your financial plan.

This process brings a method to investing and a disciplined approach that often provides investors with greater peace of mind.

Call me if you would benefit from a longer conversation and a bit of clarification on these topics. The only bad question is the one that is not asked and therefore not answered. A knowledgeable investor becomes a confident and successful investor. Learn more. You will be happier, as will your family and other organizations that are important to you.

"Someone is sitting in the shade today because someone else planted a tree a long time ago."

----- *Warren Buffett*

Fred Wollman earned his Certified Financial Planner "CFP®" professional credential in 1984 and the Master Planner Advanced Studies "MPAS®" designation in 2015. He holds securities registrations 7, 63 and 24. He is registered in California, Arizona, South Dakota, Colorado, Minnesota, Texas, Virginia, Washington, Oregon, Florida, Tennessee and Pennsylvania in addition to holding a California life and disability insurance license. From 1987 through 1990 Fred taught the CFP classes to aspiring financial professionals at San Diego State University.

He is on the board of the Valley Center Trails Association, ECOLife Conservation, and the Hidden Valley Kiwanis Club.

Fred and his wife of thirty-six years, Kathy, live in Valley Center, CA with two cats, a dog and two horses.

Fred spends his down time relaxing with yoga, tai chi, riding horses and when he can get really away, backpacking the Anza Borrego Desert, Mt. San Jacinto or the California Sierra Nevada Mountains .

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