"Diversification vs. De-Worsification"

By Tommy Williams, CFP®

The stock market tends to be a leading economic indicator. Last week offered some insight into economics and stock market behavior. The U.S. unemployment rate reached its lowest level since 1969 and wages moved higher, yet major U.S. stock indices lost value. Why didn't stock markets move higher?

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The answer is stock prices tend to be leading indicators. They reflect investors' expectations for the future. Last week, investors may have been thinking like this:

When unemployment is low, companies cannot always hire enough workers…
To hire more workers, companies raise wages…
Higher wages give workers more spendable income…
More spendable income produces higher demand for goods and services…
Higher demand for goods and services leads to higher prices…
Higher prices (inflation) cause the Federal Reserve to increase the Fed funds rate…
An increase in the Fed funds rate pushes interest rates higher…
Higher interest rates make borrowing more expensive…
Higher borrowing costs may slow business spending…
Slower business spending may cause profits to fall…
Falling profits may cause investors to sell shares…
When investors sell shares, stock prices may drop.

In general, *"…while it usually takes at least 12 months for any increase or decrease in interest rates to be felt in a widespread economic way, the market's response to a change (or news of a potential change) is often more immediate,"* explained Mary Hall on Investopedia.com.

At the end of last week, 10-year Treasuries yielded 3.2 percent. Daniel Kruger of The Wall Street Journal reported, "U.S. government bond yields rose to their highest level in years Friday as investors reconsidered the strength of the U.S. economy while selling off stocks that could be hurt by higher borrowing costs." Of course, one way to manage stock market volatility is to have a well-allocated and diversified portfolio.

Speaking of diversification, I would be remiss not to mention Peter Lynch of Fidelity Magellan fame. He framed it like this: there is diversification – not having all of your eggs in one basket and de-worsification – a condition that occurs when you have so much different stuff that it fits no strategy, goal, or simply doesn't make sense.

De-worsification is common and can happen several ways. The most common is simply a function of evolution over a long period of time whereby one simply continues to drop the "hot deal of the day" in the basket until one day it becomes impossible to manage with any efficiency.

Another common occurrence is when one "diversifies" by using many different advisors. My observations of this strategy are 1) sometimes it's tough to place your trust in just one person and 2) usually when you begin to really study what you own through various advisors there is often a very high degree of overlap. Overlap occurs naturally when all your various advisors (not knowing what their counterparts are advising) put you in substantially the same investments – completely eliminating the possibility of meaningful diversification. Often you ask this investor, are you diversified? Of course I am, look at this pile of statements – only to find that they are 90% in large cap stocks or perhaps 90% in long-term bonds. All their advisors put them in similar investments.

The solution to those who have the need to diversify by multiple advisors is to have one who is the "quarterback". That one advisor must have the tools necessary to aggregate all your various accounts into one measurable screen so you can see how truly diversified your total portfolio might be. Then, when you state your goals the quarterback can tell you important things like, are you within your risk tolerance? What are your odds of running out of money? Can you maintain your lifestyle? In other words, based on your objectives, are you truly appropriately diversified? That way you can maintain multiple relationships and still manage your wealth efficiently. And one more thing, it is hard to argue with Peter Lynch!

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