WEEKEND INVESTOR

How Much Diversification Is Too Much?

We Run the Numbers to See How Much Expanding Your Holdings Really Pays Off

By WALTER UPDEGRAVE

August 16, 2014

Pedestrians walk past the Bombay Stock Exchange in Mumbai, India. *Bloomberg News*

With all the investment options that advisers are pushing these days, you can easily get the impression that you are a slacker doomed to subpar performance unless your retirement portfolio is brimming with every asset imaginable.

But do you really need to load up with every new product that comes along? Or can a straightforward mix of stocks and bonds get you to—and through—retirement just fine?

To see how much expanding your investment holdings to include an ever-widening array of assets pays off, The Wall Street Journal asked Chicago-based investment researcher Morningstar to set up a portfolio consisting of a broadly diversified mix of 70% U.S. stocks and 30% U.S. bonds.

More from Weekend Investor ›
Why Your Cash Isn't Trash
The Payoffs of Investing Locally

Morningstar also created six additional portfolios, inserting a new asset class at each step along the way: first foreign stocks of developed countries, then emerging-market stocks, international bonds, real-estate investment trusts, commodities and, finally, hedge funds.

That resulted in seven portfolios, each with an increasingly diverse blend of indexes representing the different investments.

Morningstar provided annualized returns for the 20 years through the end of June for all the investments and the portfolios, plus data showing how each portfolio performed in 2008, the year of the most-recent market crash. All returns were before fees, with the exception of the hedge-fund returns.

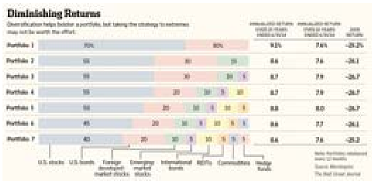
The results were both surprising and enlightening.

The portfolio that generated the highest return over the 20-year stretch was the simple 70-30 mix of U.S. stocks and bonds, with an annualized gain of 9.1%.

The other portfolios didn't lag far behind; all were within half a percentage point of the annualized return of the blend of U.S. stocks and bonds.

Reward is only one aspect of the investment equation, however. You also must consider risk. So how did that basic combination of U.S. stocks and bonds fare during the 2008 market meltdown?

It held up nicely, losing roughly 25% versus 37% for the U.S. stock market, as measured by the Wilshire 5000 index. Only one other portfolio-the one that included all the asset classes, including hedge funds-fared as well, although all the portfolios' 2008 returns fell within a tight range.



USA All the Way?

So does this mean that you should stick to a USA-all-the-way mix of stocks and bonds and ignore other assets?

Of course not. For one thing, these performance figures reflect what happened over only one period, albeit a very long stretch that included several huge run-ups in stock prices, two major market meltdowns and some sizable swings in interest rates.

The results could easily vary over different spans. You also could get different results by tinkering with the mix of assets in the portfolios.

But these results do suggest that you can reap a good deal of diversification's benefits with just a simple blend of domestic stocks and bonds.

The idea that simpler can be better often gets lost in the investment community's fascination with fads. Witness how some corporate pension funds and university endowments missed much of the stock rally of the past five years because they bought in big time to private equity and other alternative investments.

The real goal is to arrive at a reasonable balance—enough variety to provide adequate diversification but without going overboard. Even though a totally domestic portfolio excelled over the past 20 years, most experts would agree that it still makes sense to invest in foreign shares if only because not doing so would exclude more than half of global stock-market capitalization.

Emerging Markets—or Not

At the very least, you probably want to include stock exposure to developed foreign countries. As for adding emerging markets, that largely comes down to whether you feel the potential for higher returns outweighs their gut-wrenching volatility.

You can create a fully diversified portfolio of U.S. stocks, foreign stocks and U.S. bonds with just three index funds or exchange-traded funds: a total U.S. stock-market index fund, a total U.S. bond-market index fund and a developed-foreign-markets index fund. If you want to include emerging markets, you can replace the foreign-developed-market fund with a total international stock-market index portfolio (or add a fourth emerging-markets index fund).

Vanguard Group and Fidelity Investments offer low-cost versions of all these index funds; Vanguard and BlackRock's iShares also offer ETF versions of them. Annual management fees range from 0.05% to 0.33%, or $5 to $33 per $10,000 invested.

Should you diversify even more? That is a judgment call. If inflation is a concern, you might consider a Treasury inflation-protected securities bond fund or perhaps a real-estate or natural-resources fund, although you already get some exposure to these sectors in a total stock-market fund.

But you don't want to keep expanding your holdings to address every conceivable threat. Be aware, too, that the expenses charged by many alternative or niche investments can be high enough to seriously erode, if not eliminate, any diversification benefit.

Finally, consider the "hassle factor." The more your portfolio looks like the investment equivalent of a smorgasbord, the more time and effort you will have to devote to managing it. Periodically rebalancing your portfolio back to its original proportions alone could prove a daunting task.

There isn't a definitive answer for how many different types of assets you should own. But whatever number you settle on, don't feel obliged to continue adding to it just because Wall Street's marketing machine keeps churning out ever more options.

Corrections & Amplifications

A portfolio comprised of 55% U.S. stocks, 10% foreign developed-market stocks, 5% emerging-markets stocks and 30% U.S. bonds would have returned an annualized 8.7% and 7.9% over the 20 and 10 years ended June 30, 2014, respectively, and lost 26.7% in 2008. An earlier version of this article and accompanying chart about portfolio diversification incorrectly gave the figures as 7.8%, 8.8% and minus-33.1%, respectively. (Aug. 19, 2014)

More from Weekend Investor: Why Your Cash Isn't Trash