Putting All Your Eggs in Many Baskets — The Power of Diversification

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“Don’t put all of your eggs in one basket.”

You’ve probably heard this old saying used on more than one occasion to emphasize the need for a diversified portfolio, which is the equivalent of putting your eggs in many baskets.

Though diversification does not guarantee a profit or protect against a loss, a combination of asset classes may reduce a portfolio’s sensitivity to market swings because different assets — such as bonds and stocks — react differently to adverse events. For example, during the 2008 financial crisis the stock and bond markets moved in opposite directions, with stocks down 37% and bonds up 13% for the year.¹ So if a portfolio is diversified across both markets, downward movements in one may be offset by positive results in another. And even when stock and bond markets move the same direction, their movements may not be the same magnitude, which may also help reduce portfolio swings.

The chart below shows the annual returns of U.S. stocks, U.S. bonds and a combination of 65% stocks/35%² bonds from 1926 through the end of 2016. The magnitude of returns for stocks, both positive and negative, was much greater than those of bonds in almost every year with only a few exceptions over the 91-year period. By combining both stocks and bonds, the returns were steadier on a year-to-year basis than only stock returns, as illustrated by the green line.

Although the upside potential for annual returns from the diversified portfolio may also be more limited, the long-term growth potential of the diversified portfolio may be greater. This may seem illogical given the fact that the historical long-term annualized return for stocks is greater, but this underscores the impact of portfolio volatility on long-term growth.
One benefit of diversification is its potential to help shield a portfolio from large losses, which can have a devastating effect on a portfolio’s long-term growth. The larger the loss, the greater the amount needed to recover or “break-even” and this amount grows exponentially as losses increase. As shown in the chart on the left, an investment that declined 10% would need an 11% return to break even. If an investment declined 75%, it would need a 300% return to restore its original value.

The time required to recover losses is largely dependent on the particular market environment and/or the sequence and magnitude of returns following the loss. Depending on individual circumstances, as the return required to recover grows, a full recovery may not be achievable in an investors’ lifetime.

Those who stay invested in a diversified portfolio that aligns with their risk profile have a better chance of reaching their goals, regardless of the bumps in the road along the way.

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1 Stocks measured by S&P 500 Index and bonds measured by Five-Year U.S. Treasury Notes. S&P 500 represented as the Standard & Poor’s 90 from 1926 to March 3, 1957; the Standard & Poor’s 500 Index from March 4, 1957 to 2016.

2 65/35 Index Mix: 65% S&P 500 Index, 35% Five-Year U.S. Treasury Notes; rebalanced annually. Treasury notes are guaranteed as to repayment of principal and interest by the U.S. government. Fixed income investments are subject to interest rate and credit risk. All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

Stock investing involves risks, including increased volatility (up and down movement in the value of your assets) and loss of principal. Bonds are subject to market and interest rate risk. Bond values will decline as interest rates rise, issuer’s creditworthiness declines, and are subject to availability and changes in price.

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