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Speaker 1

Welcome. My name is Andrew Baron and this is Well... It Depends! the podcast where I present the pros and cons of different financial decisions so that you, the audience, feel better informed when you are confronted with these decisions in your own life. Well... It Depends! is sponsored by my firm, John G. Ullman and Associates. We are a team of financial planners, research analysts, tax specialists and support staff, all working together to give our clients a comprehensive experience.

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If, after listening, you'd like to discuss your situation with one of our financial planners, including me, please email info@JGUA.com. In this episode I ask the question, how much diversification do I need? But before we begin a short disclaimer. This is being recorded on November 22nd, 2022. The contents of this podcast are strictly for informational purposes only, and nothing said should be taken as investment, tax or legal advice.

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Any strategies discussed may not be suitable for listeners specifically, and so we strongly encourage consulting with your advisor before implementing any strategies to ensure they meet your individual objectives. Getting into it, how much diversification do I need? Well... It Depends! If you've read a little bit about personal finance, you've probably stumbled across the topic of diversification. The idea is essentially not to keep all of your eggs in one basket as it pertains to the stock market.

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Not all of the risk can be fully eliminated. This is called systemic risk. Just in case the entire system actually collapsed. Instead, we're going to talk about company specific or industry specific risk that can be mitigated by some diversification. This is called unsystemic risk. In Elton and Gruber's book, Modern Portfolio: Theory and Investment Analysis, they concluded that the average standard deviation of a stock was 49.2%.

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Speaker 1

But by adding different stocks, specifically stocks that are in different industries from each other, we can see that risk is significantly reduced as we add more stocks, but that's really only up to a point. At a 20 stock portfolio, the standard deviation can be reduced to 21.7%. That is a 56% reduction in risk. What if you keep going?

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A 30 stock portfolio reduces standard deviation to 20.9%. So even though we added 10 more stocks, it only reduced the standard deviation a little bit less than 1%. A 100 stock portfolio has a standard deviation of 19.7%, and a 1,000 stock portfolio has the standard deviation of 19.2%. Many are under the impression that each stock proportionately reduces risk.

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But instead, we see that after the first 20, the effect of reduced risk by adding additional stocks is significantly dampened. Maybe you were thinking yourself. I'll just buy one of everything and I'll reduce my risk that way. But actually purchasing one of each of the S&P 500 index components can be quite expensive. For example, Berkshire Hathaway Class A shares by themselves are currently well over $460,000 just by them self.

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More accessible way is mutual funds, and this is what many people have access to through their employee retirement plans. Buying a lot of mutual funds seems like it should give you a lot of diversification, since each mutual fund can hold a lot of different stocks.

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However, because mutual funds don't necessarily tell you what all of their holdings are, it's often limited to just the top holdings and even this can be just at a fixed point in time. You can have a lot of overlap between all of your mutual funds that you may never be aware of. So far, we've only just discussed stocks, but what about other asset classes like bonds or cash? Obviously the same idea applies that by adding more, we reduce our risk profile, but it can only be up to a certain point.

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However, ultimately we need to decide what is important to us and what is the purpose of investing. You need to evaluate what your time horizon is, what the purpose for the money is ultimately. To recap, ultimately, you need to invest in a wide array of different stocks to get the benefit from risk reduction. However, this is only true to a certain point, and each additional stock will only offer an incremental benefit.

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Speaker 1

Mutual funds can provide a low cost alternative to a wide axis of stocks, but owning a large number of mutual funds may not provide the amount of diversification you originally think. Ultimately, it's important to evaluate what your investment priorities are before simply prioritizing a risk mitigation system. So to answer the question, how much diversification do I need? Well... It Depends!

Speaker 1 – Andrew Baron, CFP®, EA