

Investment Diversification with Mutual Funds

One of the biggest benefits of mutual funds is that they provide the means for individual investors to achieve broad diversification in their investment portfolios. Although many wealthy individuals and institutions use mutual funds as at least the core of their portfolios, having considerable wealth is not necessary to construct a well-diversified portfolio with mutual funds. Indeed, it's possible to assemble a well-diversified portfolio of mutual funds with as little as \$100,000, a fairly well diversified portfolio with \$50,000 and an adequately-diversified portfolio of index funds with much less.

Having a well-diversified portfolio is important for three reasons. First, diversification can best be described as not putting all of your eggs in one basket. Mutual funds are large diversified portfolios and thus provide automatic diversification within their respective asset classes. Investing in a number of mutual funds to spread your investable funds across a variety of asset classes increases your level of diversification and decreases your aggregate exposure to risk. As investment risk is measured in terms of volatility, decreasing aggregate risk decreases the volatility of the value of your portfolio, thus sparing you the roller coaster ride that you would experience if you held only a single asset class in your portfolio, such as large-cap domestic stocks.

Second, although expected return diminishes with risk, the relationship is disproportionate and favors return. Well-conceived diversification has the potential to considerably reduce the aggregate risk of your portfolio at the cost of a relatively small reduction in your expected return. So you get a much smoother ride for a minimal cost.

Third, over the past 25 years or so, there have been a number of studies conducted that have concluded that asset allocation accounts for between 90% and 96% of your success as an investor, where success is defined as maximizing return at a level of risk that is consistent with your level of risk tolerance. Individual security selection accounts for the rest of investors' long-term success. Now, just being broadly diversified won't get you into that 90% to 96% range, but it's a big step in the right direction. A viable model that defines the composition of an efficient portfolio is required to allocate your capital across the various asset classes in a manner that will reap the full benefits of diversification.

Diversification and asset allocation are not synonyms, as diversification is just a part of asset allocation. Diversification is a matter of degree; it describes the degree to which you have diversified away company-specific risk. Full diversification within a market, in theory, eliminates all company-specific risk, leaving your portfolio exposed only to systematic risk, which is the risk inherent in the market as a whole. So, that brings up the obvious question: What is The Market?

The S&P 500, Russell 1000 and Wilshire 5000 are often used as proxies for "The Market." But they're only proxies for the U.S. stock market. To be fully diversified, you would have to be invested in all of the publicly traded securities (stocks, bonds, real estate and commodities) worldwide and your investments would have to be broadly diversified within all asset classes in that aggregation. This can actually be achieved by holding a collection of index funds.

Asset allocation describes how your capital is distributed to the diversity of asset classes you have chosen to hold in your portfolio, i.e., your investment universe. If you had chosen full worldwide diversification, your next step would be to determine how to allocate your capital across that aggregation of asset classes. One possibility would be to hold what's known as the Market Portfolio. To do this you would have to invest in all those asset classes on a market capitalization-weighted basis. That would by definition be an efficient portfolio and constructing such a portfolio is possible with index funds. It's also possible with regular mutual funds, but getting and maintaining the appropriate weightings would be pretty tricky and require a lot of time and effort.

Beyond the Market Portfolio, there are just about as many ways to select asset classes and allocate capital as there are portfolio managers, investment advisors and newsletter editors. Although they're mostly based on the same financial theories, everyone has their own model and their own forecasts to fuel their models. But going any deeper into asset allocation would diverge too far from the topic of this article...diversification.

In real estate it's location, location, location. In investing it's diversification, diversification, diversification. You must be adequately diversified, otherwise you will be exposed to too much risk with respect to your expected return. And no asset allocation model can compensate for under-diversification, as your chosen degree of diversification defines the investment universe across which asset allocation must take place. With thousands of mutual funds to choose from, there's no good reason for anyone to be under-diversified.

About the Author

Mike Kennedy created and operates [Your Complete Guide to Investing in Mutual Funds](#), a comprehensive resource for individual investors, where you'll find more on portfolio diversification and other [investing basics](#).

