Your Investment Universe Defines the Limits of Your Portfolio's Diversification

Your investment universe is the set of asset classes from which you will select the assets to construct your portfolio. As asset allocation accounts for over 90% of your success as an investor, defining your investment universe is a crucial preliminary step in constructing your portfolio. Here "asset classes" should be interpreted as "significantly different investments."

Diversification occurs at two levels: within asset classes and across asset classes. Financial theory assumes that all investors are rational and being so, they will choose to be fully diversified within asset classes. Mutual funds, by virtue of their nature, satisfy this first level of diversification. Your selection of an investment universe will determine the ultimate level of diversification achievable in your portfolio.

As assets are added to a portfolio within an asset class or market, the total risk of the portfolio decreases at a decreasing rate until company-specific risk has been virtually eliminated from the portfolio. At this point the total risk (residual risk) of the portfolio is equal to the risk of the asset class or market as a whole, i.e., market risk or systematic risk.

This principle applies also to the addition of asset classes to a portfolio. As asset classes are added, the total risk of the portfolio decreases, assuming there is full diversification within the asset classes. This can continue to the point where all asset classes worldwide are represented in the portfolio. Thus, the broader your investment universe, the greater the degree of diversification achievable and the lower your total risk.

Another way of looking at this is to consider the fact that for any given level of risk, the expected return of a portfolio comprised of assets from a broad universe will be greater than that of a portfolio comprised of assets from a relatively narrow universe.

Restricting your investment universe to large-cap domestic stocks and U.S. Treasury bonds will expose your portfolio to an unnecessarily high level of risk for the expected level of return. You can significantly increase your expected rate of return at the same level of risk by adding other asset classes, i.e., by broadening your investment universe. Portfolios constructed from broad universes dominate those constructed from narrow universes on a mean-variance basis, which is the essence of modern portfolio theory.

The top level asset classes include the following:
*Domestic Stock
*International Stock
*Emerging Markets Stock
*Domestic Bonds (both corporate and government)
*International Bonds
*Emerging Markets Bonds
*Domestic Real Estate
*International Real Estate
*Commodities (worldwide)
*Cash (money market funds/accounts, CDs, etc.)

These asset classes can be further subdivided by market capitalization, industry sector, debt quality and maturity, and in the case of mutual funds, investing style.

With so many choices, there's no reason for anyone to hold a portfolio selected from a narrow investment universe. Knowledge is power and knowledge builds familiarity. If investing in some of these asset classes seems too risky to you, you need to learn more about them to gain the familiarity required to achieve the level of comfort required to sail into what may now appear to you to be uncharted waters. Remember, although each of these asset classes alone are relatively risky, in aggregate, their risk is minimal in the long term.

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.

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