

The Wrong Kind of Diversification



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Overview: This article addresses why it would be inefficient to try to diversify assets over multiple managers. When investors keep their assets in several places, it becomes more difficult to achieve long-term financial goals. Instead, individuals can more easily coordinate their overall investment plan by choosing a single trusted advisor to manage their assets.

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Introduction

What is “diworsification”? The aforementioned word and its definition cannot be found in the Webster’s dictionary. Still, many investors may be “diworsifying” their portfolio by adding investments and/or advisors that ultimately result in increasing the risk of their portfolio.

In their efforts to diversify risks, many investors make three common mistakes because they don’t realize some types of diversification are less effective than others, some are ineffective and some can even increase risk.

Investment Diversification Issue I: Multiple Investments, Same Asset Class

Probably the most common diversification error made by individual investors is purchasing several different mutual funds in the same asset class. Owning five different U.S. large-cap growth funds provides only minimal diversification benefit. In this case, all the funds would be invested in the same basket and exposed to the same types of risks.

Investment Diversification Issue II: Multiple Managers

Investors may make a similar error when deciding who will manage the assets in their portfolio. Not wanting to have all their eggs in one basket, some investors hire several investment advisor firms, unaware that their portfolio might be exposed to the same types of risks over multiple investments.

Diversification, and the amount of risk in a portfolio, is no more determined by the number of advisors an individual has than the number of stocks he or she owns. Instead, as the academic research indicates, almost all of a portfolio’s risk is determined by asset allocation.

In addition, hiring multiple advisors can create several problems:

- Most people want to simplify their life, not complicate it. Working with multiple advisors complicates the portfolio’s management.
- Economies of scale can be lost. Advisors who charge by the amount of assets under management typically charge lower fees on larger portfolios. Investors who split their assets among several managers may miss out on such a benefit.
- Holdings may be duplicated, both in terms of individual stocks and asset class exposure. Thus, the portfolio may not be effectively diversified and may be more risky. Also, if the investor is using actively managed funds, the more advisors that invest in the same asset class, the more likely it is that investors will be paying high active management fees while owning a portfolio that looks more like a group of low-cost index funds. On the other hand, there is no need for more than one advisor if the investor believes in passive management. It is possible there could be instances when one manager buys a fund and another manager sells the same fund, for which an investor would incur unnecessary trading costs.
- If each advisor operates independently, there is the potential for inefficient tax management.
- If each advisor operates independently, style drift is likely to occur — the overall portfolio’s desired asset allocation may not be maintained. Thus, the use of multiple advisors creates the potential for actually *increasing* risk.

Investment Diversification Issue III: Lack of Information Can Weaken an Overall Investment Plan

Finally, it is in an investor's best interest to disclose all of his or her investment accounts (for example, IRAs, 401(k) and pension accounts) and financial assets (such as, stock options, life insurance, trusts) to his or her designated financial quarterback to ensure the plan is a well-integrated one. Doing this avoids duplication of holdings, minimizes style drift, and ensures the asset location decisions are correct, all of which are critical to keeping an investment strategy on course.

The Need for a Financial Quarterback

Having several independent advisors not only creates difficulties on the investment front, but could create other problems as well. Consider that it is not enough to have a well-developed investment plan. For example, it is also necessary to have the discipline to adhere to the plan.

Therefore, a prudent approach would be to integrate an investment plan into a carefully constructed estate, tax and risk management (insurance) plan because investment decisions and performance can impact other areas of the plan and vice versa. For example, there might be a well-designed investment plan in place, but the overall financial plan has not addressed appropriate life and disability insurance for the primary breadwinner. Other examples of why having a good investment plan is insufficient include the following:

- The need for extended care in a nursing home but no long-term care insurance
- Insufficient funds available to pay estate taxes because the life insurance policy was inside the estate
- Incorrectly chosen beneficiaries for the deceased's IRA account causing a loss of tax deferral

Investors should have a qualified financial wealth manager serve as the quarterback of their financial services team to ensure they have the greatest chance of achieving their financial goals. That person should be responsible for coordinating asset allocation and estate, tax management and risk management (insurance) plans, such as making appropriate adjustments as an investor's ability, willingness and/or need to take risk changes over time. For example, better-than-expected investment performance may reduce the need to take risk, allowing an investor to lower his or her equity allocation.

Better-than-expected investment performance can also impact plans in conflicting ways. For example, higher-than-expected returns might allow an investor to self-insure risks he or she had previously purchased insurance to cover (such as, life, long-term care and disability). It may also increase the family's ability to achieve other goals such as donating to charity. On the other hand, it might increase needs for life insurance, if that turns out to be the most efficient way to pay estate taxes.

Summary

While diversification is part of a prudent investment strategy, some kinds of diversification are more effective than others. Hiring multiple investment advisors creates the potential for inefficient portfolio management, and it may add unwanted complexity to an investor's life while increasing costs.

There are simple steps investors can take to eliminate the need to hire multiple advisors, including the following:

- First, investors can adopt a passive investment strategy.
- Second, they can hire an advisor who operates an "open platform" — the advisor does not sell any proprietary products and can buy any product.
- Third, they can choose to hire an advisor who not only provides investment management services, but also wealth management services.
- Fourth, they can verify that the advisor provides a fiduciary standard of care. A fiduciary standard is often considered the highest legal duty that one party can have to another. This differs from the suitability standard present in many brokerage firms, which only requires a product or service be suitable. It does not have to be in the investor's best interest.

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