Are All Your Eggs in One Basket?

By Ryan Zacharczyk, CFP, CSA, CRPC

Investing is tricky business. Who can you trust? Your advisor is telling you to buy stocks, the commentator on CNBC is touting bonds, and your brother-in-law told you he invests only in real estate. If you feel like your head is spinning from all the options, you're not alone. The number one reason most people don't start an investment program sooner is because of all of these choices. Analysis paralysis sets in when it is easier not to make a decision at all. The answer, however, is simpler than you think. What investment is right for you? The answer is most likely all of them.

Many people think they know what diversification means. But there is more to diversification than just putting your eggs in different baskets. Having a well-diversified portfolio can benefit you in ways you may not have realized and get you closer to your financial goals.

Let's imagine you're an entrepreneur and you own four businesses. In the summer, you sell beach umbrellas on the boardwalk. In the fall, you sell pumpkins for Halloween. In the winter, you sell snow shovels, and in the spring, you sell mulch for flower gardens. Each business was very successful during the appropriate time of year. In fact, on average, each business made you a nice profit for the year. But, obviously they don't all thrive at the same time. In fact, while your beach umbrella business is booming, your snow shovel business is essentially nonexistent.

What would happen if one day during mid-October, you went to your storage shed where you kept the supplies for your businesses and thought, "My pumpkin business is great, I am making lots of money, but I haven't sold mulch in a long time. I should just sell that business to someone else." So, you sell your mulch business at a bargain basement price (since it is off-season) and you continue to sell your pumpkins. What will happen come late winter or early spring? How many pumpkins will you sell in March?

That mulch business had a very specific purpose in your business portfolio. It was not to make you money all the time, just in the spring when you needed it to. Over the course of the long-term (the fiscal year) it was very profitable, but it didn't look that way in the fall.

This is often how we treat our investment portfolio. We tend to sell one asset class when it is performing poorly and purchase more of the one that is performing well. This is like buying more beach chairs on Labor Day. What will you do with all those beach chairs in October?

When designing a custom portfolio for a client, all the parts of that portfolio are there for a reason. Each asset class performs well at different times of the economic cycle. Some asset classes even perform well at random. The point is some are up, while others are down. Over the long-term, we know what to expect out of each, but they perform very differently during varying economic times.

Historically, stocks have been the long-term investment of choice. They have a fantastic long-term return, but they don't always perform well. In fact, when stocks perform poorly, bonds usually perform well. Real estate does better during periods of rising inflation. Small-caps outperform right after a recession, during the initial stages of an economic boom, while large caps take off late in economic booms.

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The fundamental principle important to understand is that anticipation of any of these cycles is impossible. It has been proven time and again that even the experts have little success timing the market and economic cycles consistently. Yet, we continue to try.

The solution to these futile attempts at fortune telling is owning many asset classes that perform well during different periods. This is the essence of diversification. This will get you the return you desire while smoothing out the bumps in the road. When stocks are up, bonds may not earn you anything at all, but when stocks are down, those bonds should have a tremendous up year. Don't sell your snow shovel business in July. Just because an asset class is not performing well during any one short-term period, it doesn't mean that it is not appropriate for your portfolio. Remember, if you do not have at least one asset class down on the year, then you are not diversified properly.

The custom portfolios I design for my clients almost always have some investment in small cap stocks, large cap growth stocks, large cap value stocks, foreign stocks, emerging markets, bonds, international bonds, real estate, and commodities. This provides the investor with numerous types of investments that perform well during different times. Winter for commodities may be summer for international stocks. This does not mean we should sell our commodities.

This portfolio will also help smooth out your returns. Let's assume we are looking to return 8% annually. Using different proportions with each of these assets, we can achieve that figure over the long term. But the real benefit of diversification comes when you see that the stock market is down, but your portfolio is up 1%. The peaks and valleys of the stock market returns will be reduced as your portfolio follows a much tighter range of returns.

Investing may seem complex. Options on where to invest your money come at you from everywhere including hired experts, television analysts, and even at your brother-in-law's Labor Day barbecue. In reality, it is not that complex. Invest in all the asset classes, diversify appropriately, and have faith that following a long hard winter, spring will arrive.

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