Exploring the Expanding Definition of What It Means to Diversify in the 21st Century

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In early 2018, the Dow Jones Industrial Average fluctuated wildly, leading many investors to make rash, emotional decisions. This, more often than not, resulted in untimely investment decisions and a decline in the value of their portfolio.

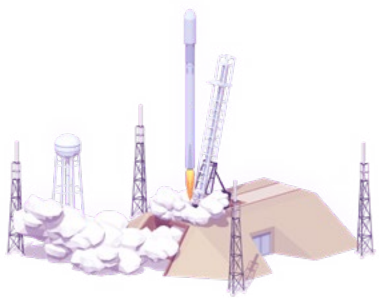
Rather than overreact to short-term market swings, many experts suggest a better idea. They say investors should embrace diversification, so they are insulated from the volatility. This approach applies not only to one's cash account, but also their retirement accounts, where some companies are making it easier than ever to invest across various asset classes.

Some important pointers were laid out earlier this year by the Financial Planning Association (FPA), which tried to take the typical investor past the idea of just "investment management" and include the concept of "financial planning." In truth, there is growing overlap between these two disciplines. The association wrote that financial planning "is a dynamic process where you develop a big-picture strategy for managing all of your financial resources – including investments – so you're in a position to fulfill your short-term and long-term goals with the flexibility to adjust on the fly as changing circumstances dictate, which includes volatility in the markets."

The premise of planning and embracing such a strategy of diversification makes sense. To get there, the FPA offered a couple good suggestions:

Adopt a Long-term Perspective

This means creating a plan that is built around diversification, which, in turn, insulates the investor from downturns in the stock market. The FPA likes to talk about the "six core areas of your financial life (cash flow, taxes, estate planning, insurance, investments, retirement planning and, when applicable, college and special needs planning)"and how they need to be structured into "a coherent, orchestrated plan, so that all the disparate parts run smoothly as a whole." No one can argue with that. And the good news is that investors may not need a financial planner to address many of these core areas, as some of them can be addressed in one strategy. Companies like Rocket Dollar, for example, make it easy to unlock retirement accounts and diversify investments into multiple asset classes, while still getting the tax benefits associated with both a self-directed 401 (k) and IRA.



Identify Priorities.

Is the goal to preserve wealth at all costs? Or is it more desirable to take some smart risks and enjoy the here and now. The good news is that both of these can be achieved through an investment strategy that embraces diversification. Take real estate for example. It typically is very stable and consistent. At the other end of the spectrum, investors may want to consider investing in startup companies. It has never been easier through crowdsourcing programs, angel networks, and direct investment.

If the above are precursors to embracing diversification, what should investors consider when executing on such a strategy?

In Are You Well Diversified? What Does That Really Mean?, Jerry A. Miccolis and Marina Goodman, wrote an article for the FPA, which address this.

> They then explore "a bit deeper into what we mean when we say a portfolio is well diversified," stressing that it is important to "appreciate that diversification is really just a means to an end, not an end in itself.

The authors began by noting that “each asset in a portfolio has a role to play, and they will generally take turns being leaders and laggards. In fact, it is just this phenomenon that is exploited by systematic rebalancing a well-diversified portfolio.”

“Its goal is to decrease the risk in a portfolio while still allowing a healthy return. The most common way to measure risk is standard deviation,” they wrote. The idea is to “decrease risk without impairing returns.” This seems obvious, of course. Elaborating, they added that “the purpose of diversification is to optimize the risk/return trade-off at the portfolio level—in both normal and stressed markets—and the means it uses to do so is mixing together poorly correlated asset classes.”

The authors went on to quote Bill Hornbarger, the chief investment strategist at the Moneta Group, who offered the following observation at a conference: “You know you’re well diversified when there is always some part of your portfolio that you’re not happy with.”

Reluctant to leave that statement hanging, they suggested reframing “not happy” to something more along the lines of being realistic.

“The natural reaction … would be to be disappointed with the laggard,” they wrote. “But … we know that this view is naïve, shortsighted, and suboptimal.”

The authors like to grade the asset classes, for diversification purposes, by considering the following three R’s – Return, Risk and Relationship with other asset classes. With regard to the last R, “the less correlated, the better.”

Diversify by Investing in Real Estate, and Even Cryptocurrency Funds

They then considered some of the non-equity asset classes, one of which was real estate. While this asset class can exhibit “equity-like levels of growth,” one of the other positive benefits is that “that they generally help protect against high levels of inflation. Real estate values and rents tend to rise during inflationary periods.”

More than ever, buying property holds an allure for investors because they can achieve both rental income and value appreciation. There are a couple ways to invest in real estate. First, they can enter into partnerships that purchase real estate investments. Second, they can issue loans to buyers and secure the loans with property. One of the most attractive things about real estate is that it is a tangible asset that you can stop by and check up on the property.

When considering physical real estate, there are a few basic categories to consider: commercial, multi-family and single-family homes.   Each obviously has its positives and negatives. But one rule holds true – more work equals more reward. Commercial can be the least labor intensive since many businesses are closed on nights and weekends, additionally they tend to sign long leases and don’t move very often. But both these positives are tradeoffs against higher purchase prices and lower returns. Multi-family properties look great on paper, but experience higher turnover and more maintenance. The latter can eat into those paper profits. The last option is the single-family property. While mundane, these tend to appreciate steadily with a workload that fits between commercial and multi-family properties.

> Investing in startups is another good option. These days, everyone has a friend or member of the family, who is building a business, or starting a brand new one. Investing in one or more of these businesses is a great way to diversify.

Investors who risk-averse and want to place a bet within a shorter-term horizon can consider making a small business loan. But a couple words of caution: Make sure and understand the business and engage a lawyer when creating a contract.

In addition, investing in a single startup is like investing in a single equity. Experts suggest spreading the risk by investing in multiple startups. "To mitigate the specific risks associated with startup investments, an investor must ensure that no single startup accounts for a significant percentage of his/her overall portfolio," according to the website Investopedia (www.investopedia.com). Rather, "diversify within this asset class to increase their probability of success and to offset expected losses in their venture capital portfolio."

A trendier way to explore alternative investments is to invest in cryptocurrencies. The beauty of bitcoin is that it can't be dragged down by economic forces that affect more traditional assets. As more consumers and investors embrace bitcoin globally, its growing value won't be compromised by a bearish stock market, falling oil prices, or a weakening dollar. As David McCormick-Goodhart, a financial adviser with Savant Capital Management, a Rockford, Ill.-based wealth management firm, recently told TheStreet.com in an article (https://www.thestreet.com/story/14526009/1/retirement-savers-should-resist-the-bitcoin-lure.html), "there is nothing wrong with an investor putting a small piece of his or her portfolio in cryptocurrency as a speculative investment, but only after all other financial ducks are in a row."

The article summarized the feeling of many, noting that "investors should be invested in multiple asset classes to avoid major corrections (in the stock market), and while adding bitcoin in an IRA or 401k is risky," it does not mirror the stock market.

The good news is this investment strategy is not restricted to the active assets account. It is now easier than ever to diversify, even with regard to retirement accounts, thanks to federal laws associated with self-directed 401(k)s and IRAs.

This strategy was recent written about in Inc. Magazine with regard to investing in startups, though the same strategy could apply to the other alternative investments. "Many new companies rely on friends and family to fund a startup or an existing company in need of capital," wrote the columnist in https://www.inc.com/darren-heitner/serial-entrepreneur-seeks-to-convert-retirement-savings-to-capital-for-funding-startups.html?cid=landermore. "Those startups now have the option of going back to friends and family and telling them" they can utilize their retirement accounts, which benefits the startup and the individual, through diversification."

The bottom line is that diversification not only provides shelter from the storm during volatile markets, but it also enables investors to grow their portfolio and realize their financial objectives.