

## The guide to diversification

Build a solid investment strategy to help realize your goals—no matter what the market does.

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### Key takeaways

- ✓ **Diversification can help manage risk.**
- ✓ **You may avoid costly mistakes by adopting a risk level you can live with.**
- ✓ **Rebalancing is a key to maintaining risk levels over time.**

It's easy to find people with investing ideas—talking heads on TV, or a "tip" from your neighbor. But these ideas aren't a replacement for a real investment strategy that can help you achieve your goals no matter what surprises the market serves up.

We believe that you should have a diversified mix of stocks, bonds, and other investments, and should diversify your portfolio within those different types of investment. Setting and maintaining your strategic asset allocation are among the most important ingredients in your long-term investment success.

Then give your portfolio a regular checkup. At the very least, you should check your asset allocation once a year or any time your financial circumstances change significantly—for instance, if you lose your job or

get a big bonus. Your checkup is a good time to determine if you need to rebalance your asset mix or reconsider some of your specific investments.

## Why diversify?

The goal of diversification is not necessarily to boost performance—it won't ensure gains or guarantee against losses. Diversification does, however, have the potential to improve returns for whatever level of risk you choose to target.

To build a diversified portfolio, you should look for investments—stocks, bonds, cash, or others—whose returns haven't historically moved in the same direction and to the same degree. This way, even if a portion of your portfolio is declining, the rest of your portfolio is more likely to be growing, or at least not declining as much.

Another important aspect of building a well-diversified portfolio is trying to stay diversified within each type of investment.

Within your individual stock holdings, beware of overconcentration in a single investment. For example, you may not want one stock to make up more than 5% of your stock portfolio. Fidelity also believes it's smart to diversify across stocks by market capitalization (small, mid, and large caps), sectors, and geography. Again, not all caps, sectors, and regions have prospered at the same time, or to the same degree, so you may be able to reduce portfolio risk by spreading your assets across different parts of the stock market. You may want to consider a mix of styles too, such as growth and value.

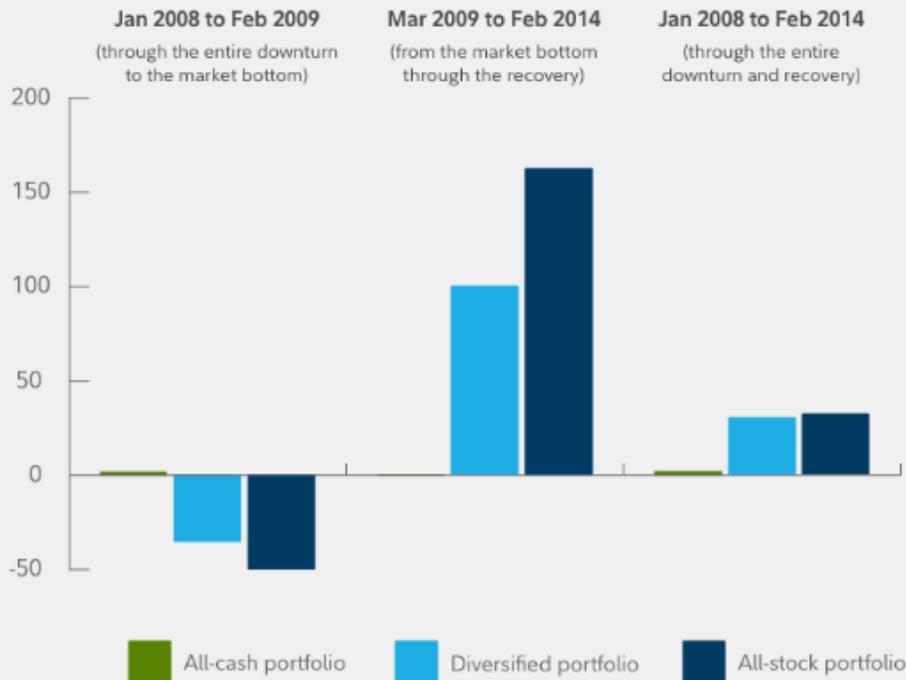
When it comes to your bond investments, consider varying maturities, credit qualities, and durations, which measure sensitivity to interest-rate changes.

## Diversification has proven its long-term value

During the 2008–2009 bear market, many different types of investments lost value at the same time, but diversification still helped contain overall portfolio losses.

Consider the performance of 3 hypothetical portfolios: a **diversified portfolio** of 70% stocks, 25% bonds, and 5% short-term investments; an **all-stock portfolio**; and an **all-cash portfolio**. As you can see in the table below,<sup>1</sup> a diversified portfolio lost less than an all-stock portfolio in the downturn, and while it trailed in the subsequent recovery, it easily outpaced cash and captured much of the market's gains. A diversified approach helped to manage risk, while maintaining exposure to market growth.

## Diversification helped limit losses and capture gains through the financial crisis and recovery



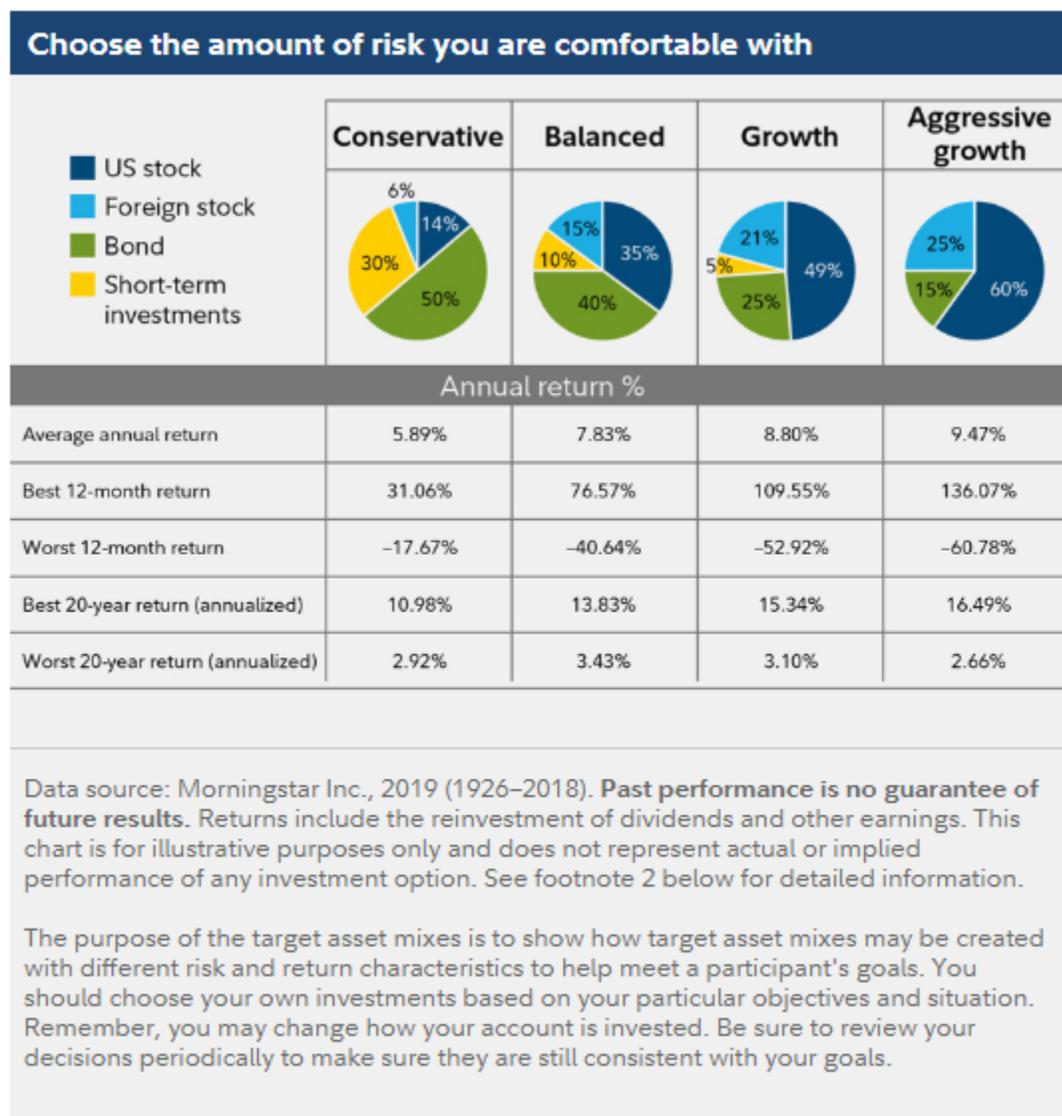
Source: Strategic Advisers, Inc. Hypothetical value of assets held in untaxed accounts of \$100,000 in an all-cash portfolio; a diversified growth portfolio of 49% US stocks, 21% international stocks, 25% bonds, and 5% short-term investments; and all-stock portfolio of 70% US stocks and 30% international stocks. This chart's hypothetical illustration uses historical monthly performance from January 2008 through February 2014 from Morningstar/Ibbotson Associates; stocks are represented by the S&P 500 and MSCI EAFE Indexes, bonds are represented by the Barclays US Intermediate Government Treasury Bond Index, and short-term investments are represented by US 30-day T-bills. Chart is for illustrative purposes only and is not indicative of any investment. **Past performance is no guarantee of future results.**

Why is it so important to have a risk level you can live with? The value of a diversified portfolio usually manifests itself over time. Unfortunately, many investors struggle to fully realize the benefits of their investment strategy because in buoyant markets, people tend to chase performance and purchase higher-risk investments; and in a market downturn, they tend to flock to lower-risk investment options; behaviors which can lead to missed opportunities. The degree of underperformance by individual investors has often been the worst during bear markets.

"Being disciplined as an investor isn't always easy, but over time it has demonstrated the ability to generate wealth, while market timing has proven to be a costly exercise for many investors," observes Ann Dowd, CFP®, vice president at Fidelity Investments. "Having a plan that includes appropriate asset allocation and regular rebalancing can help investors overcome this challenge."

### Building a diversified portfolio

To start, you need to make sure your asset mix (e.g., stocks, bonds, and short-term investments) is aligned to your investment time frame, financial needs, and comfort with volatility. The sample asset mixes below combine various amounts of stock, bond, and short-term investments to illustrate different levels of risk and return potential.

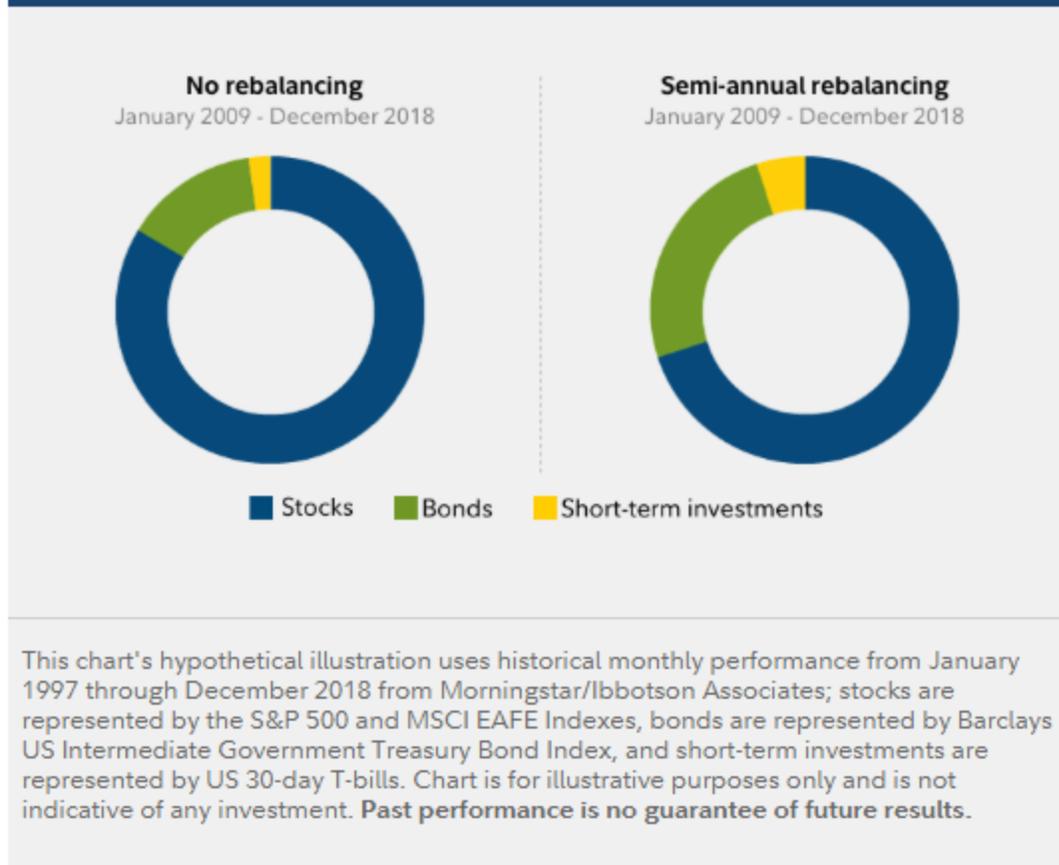


## Diversification is not a one-time task

Once you have a target mix, you need to keep it on track with periodic checkups and rebalancing. If you don't rebalance, a good run in stocks could leave your portfolio with a risk level that is inconsistent with your goal and strategy.

What if you don't rebalance? The hypothetical portfolio shows what would have happened if you didn't rebalance a portfolio from 2006–2019: The stock allocation would have grown dramatically (see chart).

## How an investment mix can change over time



The resulting increased weight in stocks meant the portfolio had more potential risk at the end of 2019. Why? Because while past performance does not guarantee future results, stocks have historically had larger price swings than bonds or cash. This means that when a portfolio skews toward stocks, it has the potential for bigger ups and downs.<sup>2</sup>

Rebalancing is not just a volatility-reducing exercise. The goal is to reset your asset mix to bring it back to an appropriate risk level for you. Sometimes that means reducing risk by increasing the portion of a portfolio in more conservative options, but other times it means adding more risk to get back to your target mix.

### A 3-step approach

Investing is an ongoing process that requires regular attention and adjustment. Here are 3 steps you can take to keep your investments working for you:

#### 1. Create a tailored investment plan

If you haven't already done so, define your goals and time frame, and take stock of your capacity and tolerance for risk.

#### 2. Invest at an appropriate level of risk

Choose a mix of stocks, bonds, and short-term investments that you consider appropriate for your investing goals.

Stocks have historically had higher potential for growth, but more volatility. So if you have time to ride out the ups and downs of the market, you may want to consider investing a larger proportion of your portfolio in equities.

On the other hand, if you'll need the money in just a few years—or if the prospect of losing money makes you too nervous—consider a higher allocation to generally less volatile investments such as bonds and short-term investments. By doing this, of course, you'd be trading the potential of higher returns for the potential of lower volatility.

Once you have chosen an asset mix, research and select appropriate investments.

### 3. Manage your plan

We suggest you—on your own or in partnership with your financial advisor—do regular maintenance for your portfolio. That means:

- Monitor – Evaluate your investments periodically for changes in strategy, relative performance, and risk.
- Rebalance – Revisit your investment mix to maintain the risk level you are comfortable with and correct drift that may happen as a result of market performance. There are many different ways to rebalance; for example, you may want to consider rebalancing if any part of your asset mix moves away from your target by more than 10 percentage points.
- Refresh – At least once a year, or whenever your financial circumstances or goals change, revisit your plan to make sure it still makes sense.

### The bottom line

Achieving your long-term goals requires balancing risk and reward. Choosing the right mix of investments and then periodically rebalancing and monitoring your choices can make a big difference in your outcome.

1. Source: Strategic Advisers. Portfolio risk is measured using standard deviation, which is a statistical measure of how much a return varies over an extended period of time. The more variable the returns, the larger the standard deviation. Investors may examine historical standard deviation in conjunction with historical returns to decide whether an investment's volatility would have been acceptable given the returns it would have produced. A higher standard deviation indicates a wider dispersion of past returns and thus greater historical volatility. Standard deviation does not indicate how an investment actually performed, but it does indicate the volatility of its returns over time. Standard deviation is annualized. The returns used for this calculation are not load adjusted.

2. Historical returns for the various asset classes are based on performance numbers provided by Ibbotson Associates in the Stocks, Bonds, and Inflation (SBBI) 2001 Yearbook (annual update work by Roger G. Ibbotson and Rex A. Sinquefeld). Domestic stocks are represented by the S&P 500® Index, bonds are represented by US intermediate-term government bonds, and short-term assets are based on the 30-day US Treasury bill. Foreign equities are represented by the Morgan Stanley Capital International Europe, Australasia, Far East Index for the period from 1970 to the last calendar year. Foreign equities prior to 1970 are represented by the S&P 500® Index.

This information is intended to be educational and is not tailored to the investment needs of any specific investor.

**Past performance is no guarantee of future results.**

Diversification and asset allocation do not ensure a profit or guarantee against loss.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Indexes are unmanaged. It is not possible to invest directly in an index.

The S&P 500 Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent US equity performance.

The MSCI® EAFE® (Europe, Australasia, Far East) Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors in developed markets, excluding the US and Canada.

The Barclays US Intermediate Government Bond Index is a market value-weighted index of US government fixed-rate debt issues with maturities between one and 10 years.

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Fidelity Brokerage Services LLC, Member NYSE, [SIPC](#), 900 Salem Street, Smithfield, RI 02917

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