Portfolio Overlap: Too Much of a Good Thing

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As a general rule, investing your money in different types of assets is a good way to reduce the risk of loss in your portfolio. Yet, while this is an important aspect of sound investing, it doesn't guarantee a diversified portfolio. Your investments may still overlap too much, diluting the benefits of diversification. Overlap can occur when you hold too many assets that are invested in the same companies or market sectors, or when you invest in several funds from the same provider.

Say, for instance, that two funds in your portfolio have Google as their top holding. Because of the overlap in Google stock, your portfolio isn't as diversified as it could be. And the problem worsens if the funds have several other stocks in common; should the overlapping companies suffer significant losses, the impact on your entire portfolio would be magnified.

Overexposure to a particular industry or market segment can also pose a problem. For example, let's say XYZ Technology is a major holding in your portfolio. Your other investments may not have holdings in XYZ Technology, but if they have significant holdings in other technology companies, you could be overexposed to that market sector.

Minimizing overlap

Limiting overlap is one of the most important steps you can take to reduce risk in your portfolio. Still, you probably won't be able to avoid overlap altogether, as many funds invest in the same companies. Your goal should be to minimize overlap, not totally eliminate it. One way to estimate the amount of overlap you may have in individual assets and specific market sectors is to compare the top holdings of all your funds. You can easily find the top holdings in your funds' annual or semiannual reports; most fund fact sheets also include this information.

If you determine that two funds in your portfolio significantly overlap, experts usually advise selling one. Deciding which fund to sell can be challenging, but it may help to consider which one has performed better and which one is more expensive. Or, make it easy on yourself and consult with a financial advisor.

To avoid overlap and stay on track to reaching your retirement goals, it's wise to review your investment mix on a regular basis. Keep in mind, however, that diversification does not ensure a profit or guarantee against loss.

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