



## So You Think You're Diversified?

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Diversification is a key tenet of investing as it reduces your risk exposure to bad events and collapses in the value of any one asset. If your entire portfolio consists of five stocks, a single company doing bankrupt will cause you to lose 20% of your investment dollars. If, instead, your portfolio consists of 20 stocks, that one company going bankrupt will only cause you to lose 5% of your portfolio's value. The idea of diversification is to reduce risk, and this can be done by choosing a number of stocks varying by industry, sector, and company size. Maintaining a diversified portfolio of high-quality stocks is ideal.

But how much diversification is too much? At what point are you adding investments to your portfolio just for the sake of diversifying? There's a fair amount of research that has calculated the level of diminishing benefit to

diversification: beyond 30 stocks in a portfolio, the average standard deviation of annual portfolio return essentially levels off.

A default solution for many investors to achieve diversification is to own the S&P 500 index either through a low-cost mutual fund or exchange traded fund (ETF). The rationale is that the S&P 500 is widely used benchmark for the stock market as it's referenced on a continuous basis on TV, the internet and in newspapers, and because in theory it represents the U.S. economy as a whole.

As a result, owning the S&P 500 for exposure to stocks in a portfolio has arguably become a crowded trade as investing tends to have a herd mentality. And, as often happens with investing, things are not exactly what they seem.

Theoretically, the S&P 500 would be a good diversification tool if it owned equal amounts of each company. In practice, however, this is not the case as the S&P 500 is not an equal-weighted index. The S&P 500 is a "capitalization weighted index" meaning that companies that are worth more have an outsized influence on how it performs.

As a result, the S&P 500 typically relies on a handful of stocks for its performance while the majority have much less impact.

In recent years, the major beneficiaries of this dynamic are the FAANG stocks (FB, AAPL, AMZN, NFLX, GOOG....and MSFT). The proliferation of index funds and ETFs and the attraction of them by investors as a diversification tool has accentuated the flow of capital into FAANG stocks. In 2012, these five stocks represented about 6% of the S&P 500 and today they represent closer to 13% of the index.

For the first half of 2018, the FAANG stocks were up 3.38% and the S&P 500 was up 2.65%. How is this possible? It's possible because the other 495 stock in the S&P 500 collectively were down by .73% over the same time period. So as the FAANG stocks go, so goes the S&P 500. And perhaps it's not providing the diversification that investors are expecting.

Another consideration is the fact that the FAANG stocks are all technology stocks. Technology stocks now represent 26% of the S&P 500, a weighting that has become so large that the index committee at Standard & Poors is

actually changing how they categorize some of the stocks in the index this month (9/21). They are moving some of the FAANG stocks into other categories and creating a new classification called Communications Services.

While this window dressing by Standard & Poors will reduce the overall technology weighting in the S&P 500 index, it will not eliminate the ongoing issue of having a handful of stock dominate the indexes performance.

Given that nothing lasts forever, a good question to ask yourself is what happens to the S&P 500 when these companies are no longer the stock market's darlings?

And you should consider if you are really diversified. A good time to reflect on this may be today when things appear really good and when it seems hard to go wrong with the momentum of FANG stocks. When the tech bubble collapsed in 2000 and 2002, other sectors like real estate and energy provided a good hedge. But when the housing bubble collapsed in 2008 and 2009, only fixed income provided a hedge.



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