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The 3 dimensions of healthy asset diversification

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I am sometimes asked to explain the difference between speculation and investing.

Speculation increases risk without increasing overall return. In other words, speculation is gambling. Investing, on the other hand, only accepts risk for a higher expected return. Risking one's capital to make money is known as capitalism and is very different than gambling.

Diversification is critical to investing and there are three dimensions to this diversification.

Asset class diversification

All asset classes do not move up and down at the same time. For example, when the stock market was in free fall after the market bubble bust in 2000, precious metals stocks, REITS (real estate investment trusts) and bonds did quite well.

Richard Ferri, author of "All About Asset Allocation," says it's important to own asset classes that are fundamentally different from each other and not consistent in the movements with each other.

The problem is that most investors do just the opposite. In early 2000, who wanted to be in those alternative asset classes when they believed the new age economy meant the stock market was going to continue to earn 30 percent annual returns?

Yet the same thing is happening today when money chases the asset classes that have done the best, such as energy and precious metals.

Earlier this year, I was interviewed by Money Magazine about what I thought about gold. What they wanted was my take on whether gold was going to continue to hit new highs, but what they got was my opinion that it should be used strictly for diversification purposes.

Because gold had increased, that meant that people should be selling some in order to rebalance to the targeted asset allocations.

Owning different asset classes doesn't mean you're smarter than the market, it only means that you want to minimize risk without giving up return.

Diversifying the number of holdings in each class

Let's say, for example, I determine that 30 percent of my holdings should be in large U.S. companies. What really matters here is how I allocate that amount.

Sure, if I pick a handful of stocks, I could get lucky and pick a Google, or I could get unlucky and pick stocks like WorldCom or Enron. This is speculation with a capital "S."

On the other hand, by picking hundreds of individual securities within each asset class, I can get the same expected return without taking nearly as much risk. This can be done by buying mutual funds with small amounts of money.

Broad index mutual funds, or Exchange Traded Funds, give you more bang for your buck by owning the largest number of underlying securities with the lowest costs. For example, a total U.S. and a total international index fund can own thousands of securities with ultra-low costs.

Your expected return will be roughly the same as even the professional stock pickers, but your level of risk will be much lower.

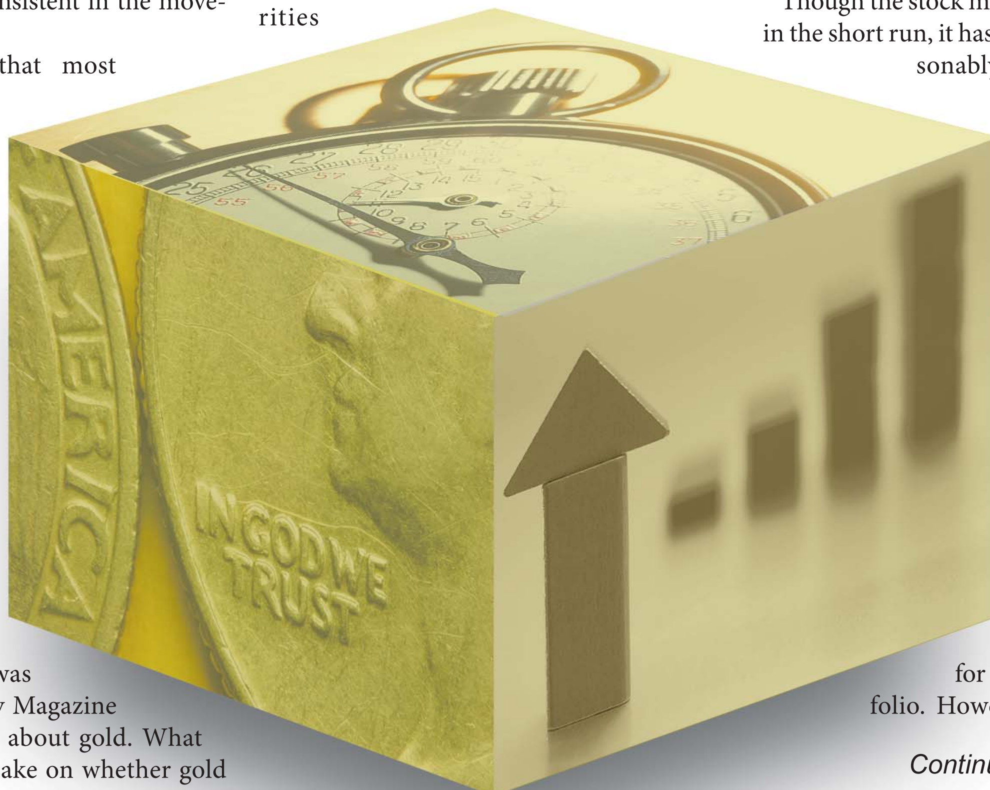
Time diversification

The above two types of diversification are known as modern portfolio theory. Yet there is a third way to diversify that most people have never heard of. Though it may sound as if you have strayed from finance to physics, that third dimension is time.

If you can stick to your strategy of owning a large number of securities within each asset class, time will decrease your risk.

Though the stock market can be very risky in the short run, it has also tended to be reasonably predictable in the long-run. Over any 10 year period, the stock market has been no riskier than bonds. And over a 30 year period, the stock market has always bested inflation by at least 2.6 percent annually.

If you need the money during the next few years, time is not on your side and the stock market probably isn't the right place for this part of your portfolio. However, if you have the



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luxury and discipline to rebalance your asset classes every year or so, time will be your best friend.

So, why doesn't everyone do this?

I would argue that all of the above can be accomplished with a handful of funds. By integrating all three dimensions of diversification, and keeping costs and taxes low, we can easily increase our odds in investing.

Unfortunately, we are often our own worst enemy in accomplishing this by believing that either we or our experts are smarter than the market. Case in point, I often hear people telling me that investing in India is the place to be because the economy is poised for continued growth.

That may be so, but this opinion is not exactly a secret around the world and is likely already priced into the stock market. Interestingly, the fastest growing emerging market countries tend to be relatively low performers when it comes to their stock market.

Speculation can be fun. However, for those who want to maximize return while minimizing risk, I suggest 3-Dimensional diversification.

Can low-cost, tax-efficient 3-D investing really help? You tell me.

By my calculations, this strategy offers a 99 percent probability of greater long-term returns and reaching financial independence a decade or two earlier.

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3-Dimensional Diversification

Richard Ferri, author of "All About Asset Allocation," offers the following advice:

Asset class diversification

Buy asset classes that are fundamentally different than one another and have historically consistently moved inconsistently with each other.

Make sure you own asset classes that have an expected positive real return after inflation. For example, owning precious metals and mining stock funds are superior to owning gold itself.

It's also critical that the least tax-efficient vehicles, like REITS and corporate bonds, be put in a tax-deferred vehicle like an IRA.

Diversify the number of holdings in each asset class

It's important to own a large number of holdings in each asset class.

Index funds, ETFs and low-cost passive funds like Dimensional Fund Advisors offer this diversification, along with great tax-efficiency.

Time diversification

Once you pick a strategy of asset allocation, stick to it. One must rebalance periodically such as on an annual basis.

Tax-efficiency must be considered during that rebalancing.