EBI - Principle #2: Diversify Your Asset Classes

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Keith: Welcome to episode 14 of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host, Ruben Antoine, for today's show. How are you doing today, Ruben?

Ruben: I'm very well. And you?

Keith: I'm great, thank you. In our last show, we introduced our audience to the first principle of evidence-based investing, which was to invest in asset classes. In today's show, we're going to focus on principle number two of evidence-based investing, which is to diversify your asset classes. We'll explore the history and the story behind diversification, discuss and review data that suggests Canadians, unfortunately, still are not diversifying the way they should be, and finally, discuss the core benefits of diversification—why investors should consider this strategy and use it within their investment approach. So, Ruben, talk to us about why we have a set of principles within evidence-based investing.

Ruben: Yes. Why we are doing that is because we are providing investors with a framework they can apply in their portfolio or with the help of their investment advisors. This framework has four steps, which are the four principles we have started covering. The first principle is to invest in asset classes, which we covered in the last show. So, investors should try to buy the whole asset class instead of trying to pick stocks or predict the market. The second principle is what we're going to cover in this show right now: to diversify those asset classes, like Keith said. In the next few episodes, once you know you need to buy an asset class and diversify it, it's how you get exposure to those asset classes and which investment vehicles you can use. So, this is what we're going to cover in the next few episodes, along with how you can try to increase returns by capturing factors, which is going to be the fourth principle.

Keith: Yeah. So, what we're doing by dividing the evidence-based into four principles, we're trying to show a map. And if you jump from one step to another, it really helps show direction and guidance. It's so critical within the Empowered Investor framework. The story we've started this whole show by talking about Canadians—they want to be able to move forward. They want financial security. They want to do it in a way where they feel like they've got control and understand how to do things.

Ruben: Yeah. I really like the fact that you're using the map as an example because when you think of a map, if you don't have a map and you are driving, you want to go somewhere, you get lost, you will be stuck. And when you have a map, you have a plan of where you need to go and how to get there. So, this is what this framework is about: to provide that map that helps you, protects you from noise, and protects you from obstacles that can affect your investment journey.

Keith: Okay, fantastic, Ruben. Thank you. That makes total sense. Now, so we've got our map. We're talking about how it fits in. Let's dive right into principle number two: diversifying your asset classes. What exactly does that mean?

Ruben: So, in terms of diversification, this means that when you have your retirement savings, your assets, you need to spread them over different types of asset class investments. You need to ensure that you don't invest only in one asset class but in many of them because they tend to react differently, and this will reduce the risk of your portfolio.

Keith: So, let's go over asset classes. What are the different types of asset classes we want investors to think about as we go through this show?

Ruben: Yeah. So, investors should ensure that, for example, if they invest in stocks, they don't only own one stock of one company or, more broadly, a stock of one region. They shouldn't only own stocks of the Canadian market, for example. They need to ensure that they have Canadian stocks, international stocks, and exposure to emerging markets as well. This will provide them different asset classes in terms of region, and that's how we can achieve diversification.

Keith: That makes sense. So, can you give us an example of naïve diversification or diversification that's not well thought of?

Ruben: So, if we continue on the stocks example, naïve diversification would be if you were to just pick a couple of companies or sectors randomly without really looking at how they interact with each other. This is when we are talking about stocks. But if we are talking about asset classes, another type of asset class is bonds as well—bonds and fixed income securities. So, you don't want to be just selecting random funds, random mutual funds, or random investment vehicles. The key is to ensure that you select, with the help of your investment advisor, asset classes that tend to react differently, that don't always move together. So, when one zigs, the other one can zag. And that's how you do proper diversification.

Keith: Yeah. Going back to some of the earlier shows with Marcelo, we had one of the pitfalls being a lack of diversification. So, you know, it is one of the critical issues that Canadians, unfortunately, might succumb to. And we often see—I've been doing this for a long time—investors come in and they'll say, "Keith, take a look at this portfolio. What do you think?" We can often see portfolios that are just a random set of securities or investments. And you ask the person, "Why did you buy that?" And they would say, "This was four years ago. I heard a story and it made me want to invest in that company." So, you often hear storied selections as to the description behind why securities are in certain clients' portfolios or certain individuals' portfolios. Do you have any stories, Ruben, in terms of what you've seen about bad diversification or poor diversification?

Ruben: A recent story I have about a client was that a client wanted to have gold in his portfolio, for example. And when you think about that, when we looked into the portfolio, we saw that there was a big exposure to the Canadian market, which already has some gold exposure. So, it's really to look at, "Are you going to be overexposed on that type of investment?" and to see if you should have more or ensure that your portfolio is more diversified across other asset classes. So, that's one example—to ensure that there is no redundancy or no overlap or too large exposure to one type of asset. So, it's something to be careful about.

Keith: Okay. That's fantastic. So, Ruben, let's dive into a bit of the data here. And the data revolves around, are Canadians properly diversified? We're going to refer to one research piece in particular, and then we're going to make some comments. So, tell me, are we diversifying as a nation properly?

Ruben: We found a study that was done in 2017 by Vanguard, one of the largest asset managers in the world. And what they showed in the study is that Canadians are not necessarily properly diversified because what happens is that Canadians tend to have a really large exposure in their own market. So, the study shows that basically Canadians tend to have 60% of their stocks in Canadian stocks. So, 60% of their equity exposure is in their own Canadian stocks, which is what we call a home bias, and it's quite a large exposure.

Keith: What's wrong with that? If you live in your country and you say, "I know the securities and I follow," what's wrong with putting 60% of your money in your local market?

Ruben: Yeah. At first, you can think that because you are familiar with that market, you know about that market, it's the right thing to do. But there's something really particular about the Canadian market. Not only is the Canadian stock market a really concentrated market, but what I mean by that is that the exposure of this market is mostly in a couple of sectors. It's on many sectors, but there's a large exposure to the financial sector, energy sector, and resources. So, just financial and energy together make up 50% of the whole Canadian market. So, it's a really concentrated market. And this is a bit risky because it's not diversified over different sectors.

Keith: Yeah, absolutely. The same report speaks about home bias. And so, home bias is the idea that investors feel comfortable with the country they live in. And so, they tend to invest more of their personal assets at home. The Vanguard report shows five or six countries. And unfortunately, we're probably at the extreme as a nation in terms of the overextension of our home bias relative to what our stock market makes up. So, our stock market in Canada makes up 3% of the global assets, and we put 60% of our assets in. So, that's a large spread. The only other country that I think is perhaps more guilty of home bias, according to this research, is Australia. And these are things that investors in different regions—they have to break these home biases. They have to break it. Why? Because there are opportunities that investors can get if they can just diversify away from their market. What are the opportunities that Canadians are missing, Ruben, by diversifying just in Canada?

Ruben: Yeah. So, like I said, because of the concentration in three sectors, there are other sectors that Canadians are not benefiting from the opportunity. For example, they can have more exposure to the tech industry, the health industry, and industrial. So, right now, by having that concentration in the Canadian market, the opportunities are being missed, basically. What about you, Keith? Do you think that there is a specific reason why Canadians are not diversifying enough? Is it because they don't know about it, or is it because of familiarity?

Keith: I think global investors at large are unfortunately a bit guilty of this concept. And Canadians have had a tendency of being attracted to their local companies. They like the concept of dividend investing. So, dividend investing tends to come from sometimes energy, pipelines, banks, and that's our natural market. But it is something that we have to work hard to expand our opportunity set because the world has thousands of amazing companies out there and Canadians need to capture that exposure—not just for the sake of capturing more exposure but also to create and build better portfolios.

Ruben: Do you think it's mostly individual investors that are doing that, or do financial advisors tend to have that home bias and overweight the Canadian market?

Keith: That's a good question. I know that the pension fund space, for example, if you break down what Canadian pension funds are doing, Canadian pension funds are not allocating as much to Canadian equities as individual Canadian investors are. So, the most sophisticated accounts are, in fact, getting better levels of diversification. I'm not sure if it's advisor-driven or if it's investor-driven, but individual investors have to diversify better. There's an opportunity. On top of that, the Canadian stock market has been one of the worst-performing stock markets in the last decade. So, unfortunately, by falling prey to a bit of a home bias or by under-diversifying, we've also set ourselves up for lower returns. And that's not good for our pensions, for our retirement. And so, we have to find a way to start building better portfolios. Now, part of this fits into the history behind diversification. So, Marcelo—here I have...

Ruben: That's okay. You've done so many episodes with Marcelo. That's okay.

Keith: Oh my God. I'm so sorry, Ruben. Maybe we'll cut that. Maybe we'll keep it in.

Ruben: No, we keep it. All right.

Keith: Okay. Ruben, so talk to us about the history of diversification. Usually, when individuals think about history, it doesn't seem as interesting or appealing. But always within the history of a subject, you determine why did things start, what created the impetus to put this into play. So, what was the history behind diversification?

Ruben: Yeah. So, diversification, the concept about spreading your assets so that you can reduce risk. There was a graduate from the University of Chicago in the fifties. His name is Harry Markowitz. So, he did some research on that. He discovered that you could actually diversify your assets, and when you do that, you could reduce risk. But you're not necessarily sacrificing return, which is amazing because people would think that if you are spreading your assets across different assets, you might get less return because you're getting less risk. But this research showed that you can keep the same level of return but reduce the risk of your portfolio. And I think that was a big discovery back then.

Keith: Yeah. And in addition to what you just said, he discovered that if you mix asset classes—different asset classes—something magical happens. The magic is in the fact that you get two positives that come out of that. You increase your returns versus if you just stayed in one or the other asset class. So, by mixing the two, you increase your return and you decrease your volatility. So, you get a double win there. What's behind that double win? What did he discover?

Ruben: Yeah, it's a concept called correlation. So, what that means is, correlation is if you take two assets that are not positively correlated—that means they don't react exactly the same way to the same event—if they just react a bit differently.

Keith: That means you're talking about the zig and the zag here.

Ruben: Exactly. Exactly. Like I said before. So, that means that's where there will be a benefit in your portfolio because, to the same event, if one asset reacts one way—zigging—and the other reacts another way—zagging—that's when you can reduce the risk of your portfolio.

Keith: Very cool. Very cool. So, another way of thinking about that is, if you mix Canadian stocks and U.S. stocks as two ingredients, one might zig, one might zag because they're made up slightly differently. But when you put them together, you'll get a better portfolio.

Ruben: Exactly. Because when one is maybe reducing in value, the other one might increase in value, and overall, together, your portfolio is more stable.

Keith: More stable. And then, if you do that but not just include two asset classes—let's just talk about equities now for a sec—you might include five asset classes, four asset classes. You've got some that are zigging, some that are zagging, but now you've got four different components moving at the same time. And when you blend them together, technically, you have gotten a smoother ride at a slightly higher expected return.

Ruben: Exactly. Exactly. That's why this whole diversification and the benefit of the diversification and the correlation, when it was discovered by Harry Markowitz, it was a big breakthrough, and his research earned him the Nobel Prize.

Keith: Yeah, I can imagine. Because prior to that, if you go back into the era of the Depression, people were looking at the stock market and using it more as a speculation machine and building portfolios with three to ten companies. And imagine if a couple of them went bankrupt. It's an extremely risky proposition.

Ruben: Exactly. And that's exactly what happened in the Depression of the 1930s, right? People were holding three to five stocks. That was the way people used to invest back then. And like you said, if one or two of them go bankrupt, you can have 20-50% of your portfolio just wiped out.

Keith: I can imagine that Markowitz's discovery did some pretty interesting things to the investment industry. What are some of the things that were created because of Markowitz's initial discovery in the fifties? What came in the sixties, seventies, and eighties?

Ruben: Exactly. So, when he was able to show the benefit of diversification, of course, when you have investment vehicles such as mutual funds, those investment vehicles benefited from his discovery because the expansion made them more popular. And they actually provided more access to the small investor because the small investor now could invest with $100, for example, in a mutual fund. And then they can get instant diversification, which was way more difficult back in the day when you needed to deal with a broker to be an investor, and it was really expensive to do.

Keith: Yeah, exactly. So, part of the story behind diversification is created in the fifties. Pension funds were able to use it in the sixties and seventies. Retail individuals were able to start getting access to this strategy by way of mutual funds in the seventies, eighties, and nineties. And then the most recent development, which is exchange-traded funds around the late nineties, early 2000s, has really provided this amazing opportunity for retail investors to diversify and to use these strategies.

Ruben: So, it doesn't necessarily look like it is a revolution to the people that don't know about that whole story. But would you say, Keith, this was a revolution in the asset management industry?

Keith: It sure was the start of a strategy that then allowed people to move forward. And then that strategy forced the creation of better mousetraps being these instruments that could be used in order to capture and put the strategy in place. So, if you look at the fastest-growing investment assets in the world right now, those would be exchange-traded funds. And that is one of the core messages that we'll see in our next show: indexing through either mutual funds that index or ETFs. This is a huge revolution that's been going on now for about 20 years. So, we've spoken about the types of asset classes. We've spoken about diversification. Ruben, if it was so easy, why aren't we all simply doing it?

Ruben: I think diversification is a great concept. There are a lot of benefits, but you have to have discipline. When you spread your money across different asset classes and you are properly diversified, that actually means that there will be some periods of time where one of the asset classes or two of them will not be performing as well. So, you need to be able to be disappointed about a portion of your portfolio and stick to it.

Keith: Ah, that's pretty critical. You're absolutely right. Because that's hard to do. Imagine if you were told, "Here, hold these five things," and you lived through a decade where two of them aren't doing very well. You get disappointed.

Ruben: Yeah, yeah. And that's when you might get out of that plan, and that's when you can make errors.

Keith: Yeah. It reminds me, quite a while ago, I used to help investors—not necessarily clients, but individuals would come and they would say, "Keith, I'd like to start saving. I want to do this." I would say, "Okay, listen, here's a great plan. Follow this." I think, take your money, divide it into four sections. And let's just say this is a 100% stock portfolio. You're going to put a section in Canada, a section in international, a section in the United States, maybe a section in emerging markets—maybe not a quarter, but something in that style, if you will. And I would tell them, "Go. And in a couple of years from now, please come back. We're going to have a review. We'll sit down." Guess what happens when they would come back? I would look at their portfolio and say, "How come it doesn't look the same as what we discussed?" One of the pieces of the pie is now 50%, and the other pieces are all quite a bit smaller. Like, what happened? And the 50% pie, by the way, was Canadian equities. This would have been around 2005, 2006, 2007. The individual would have said, "I was looking at my portfolio, Keith, and there's these two sections that weren't doing really well. And I really didn't feel like holding them that long because they weren't performing. You know what it's like. I need to get into performing asset classes." And that simple story to me shows why it's just so hard sometimes to hang on to things that might feel out of favor. Because when they come back in favor, they can come back fast. The best performing asset classes in the last 10 years have been U.S. equities. And it was very hard to find Canadians in 2008, 2009, 2010 who wanted to hold that much U.S. equity because it was right after the last decade. It was right in the middle of the financial crisis. It was easy from an optical perspective to say, "I'm not touching the United States. It doesn't look good." You're absolutely right. Diversification means you will be holding winners during that period of time, and then you'll be holding things that are lagging. That's such a great way to think of it.

Ruben: And when you think about it, some investors, their portfolio is made up of stocks and bonds. But it's really surprising if you look at between 1965 and 1981, bonds actually outperformed stocks for 16 years. And we all know that for a long-term investor with the right risk tolerance, they need to have stocks in their portfolio. But can you think about that? Sixteen years where your stock underperformed your bonds? That can make an investor want to get out of stocks, but that doesn't mean it's the right thing to do. So, it requires a lot of discipline to have a diversified portfolio.

Keith: You're talking about the sort of the famous long stock recession in the sixties and seventies. And that was actually a very difficult time to be an investor, period, because even bonds—interest rates skyrocketed up to 18% around '81. So, think about it. You're holding a portfolio, you have massive amounts of inflation, you're not doing well in any asset class. Very discouraging time. You're absolutely right. So, what are the other things that we need to consider when diversifying a portfolio? Other concepts that kind of allow this strategy to succeed?

Ruben: As an investor, once you have a diversified portfolio, there is the whole rebalancing concept that you should be aware of. So, rebalancing means you need to ensure that all your asset classes and the allocation you chose to have in them stay in balance. So, basically, when one asset class goes up, you need to have the discipline to sell a portion of it to reinvest in the other asset classes. It's an adjustment to ensure that your portfolio stays in balance.

Keith: Okay. And so, you're selling asset classes that have done well and repurchasing asset classes that might've lagged.

Ruben: Exactly. So, if you go through a crisis like what we just had with COVID, for example, when we saw stocks going down, the right way to rebalance—if that portion of your portfolio doesn't represent the exposure that you wanted to have but you have some bonds—you need to sell some bonds to reinvest in stocks. And this will allow you actually to have the disciplined process of buying assets when they are low and selling them when they are high, which is what a good investor should be doing all the time.

Keith: Yeah, what you're talking about is maintaining a diversified approach, which means you need to be adjusting because over time things will get unadjusted.

Ruben: I think with clients you have that haircut analogy that you are sometimes telling the client when you want to spend. Rebalancing. Do you remember it?

Keith: Everybody has to go for a regular haircut, sorry. And so, a portfolio is no different. You're just constantly trimming and taking care and maintaining, making your portfolio look good. So, Ruben, you and I have been meeting new clients as they've come on board for the last five years together. We go through the lifeboat drill that Rob McClellan shared with us many years ago.

And in that lifeboat drill, we talk about what we would do during bear markets or challenging markets. And usually, what we speak to is this rebalancing concept that during bear markets, your stocks will shrink because they go down. And so, at the bottom of the market, when often investors do the wrong thing and sell, a proper rebalancing strategy would be to sell bonds and buy stocks. Those are potential clients that we sit down with. How do they react to that concept when we share that idea with them?

Ruben: I think the whole buying stocks when they go down is counterintuitive at first, but it's the right thing to do because when you think about it, stocks are going down—they are cheap, they are a good price. That's when you want to buy them. And when you properly explain it to the client, it completely makes sense. They understand it.

Keith: Yeah, the other way to rebalance is not necessarily to be buying or selling anything in the portfolio. You can rebalance through cash flows. So, for a retiree, for example, who's taking money out of a portfolio, you would be taking money out of the asset classes that have appreciated the most. So, you're selling the winners. And if you're, for example, somebody who's accumulating, often what you do is you buy into the underperforming asset classes as you top up because that's what needs to be rebalanced. So, you're buying cheaper out-of-favor companies or securities. So, what it's doing is it's forcing you to do what most investors now believe is the right thing, which is sell high, buy low, as a maintenance process.

Ruben: Exactly. Because it will be very dangerous for a portfolio if you do the opposite—if you're actually selling low and buying high. And Keith, listen, I found a great quote that kind of summarizes all we just discussed about. And it's a quote from a merchant and a banker from the 15th century. So, centuries ago. His name is Jacob Fugger. And back then, he was one of the richest men in the world. And his family used to control the whole European economy. So, he said something like this: "Divide your fortune into four equal parts: stock, real estate, bonds, and gold coins, and be prepared to lose one of them most of the time," which is what you are talking about. Whenever performance differences cause a major imbalance, rebalance your fortunes back to the four equal parts." Wow. Amazing, huh?

Keith: Yeah. That's the first time I've heard that. So, what year did he write that?

Ruben: The actual quote, the year of the quote, I don't know, but he is a banker from the 15th century. So, you see, some people had the wisdom of diversification and also rebalancing even centuries ago.

Keith: Yeah. That's amazing. In so many regards, it's common sense, but it's so hard to do in practice.

Ruben: Yeah, yeah.

Keith: That's a great story. So, Ruben, we're going to start wrapping up here. What would be your takeaway for today's episode, which is to diversify your asset classes? What's the takeaway?

Ruben: My key takeaway for the listeners is that I invite them right now, in the next few weeks, if they can have a look at their portfolio with their investment advisor or by themselves to see if they have too much exposure to one region or one sector. I know a lot of people are investing in tech stocks right now. Not to one country, one asset class. If your home is your biggest asset, look at your portfolio to see if you have too much real estate. And if this is the case, try to diversify across other regions, other asset classes, just to add more, not only return opportunities in the portfolio but to ensure that the portfolio has less risk by having less exposure to one type of asset.

Keith: All right. I think that's a great call to action. And that's what I'd like to leave listeners with. So, very well said, Ruben. So, let's wrap it up and discuss what we're doing next. As we move into the next show, we're going to be going into principle three, which is to choose your asset class investments wisely. And we'll share with the listeners what that means in the next episode. So, until then, be safe. Thank you so much for tuning in to the Empowered Investor, and we'll see you in two weeks from now.

Ruben: Thank you. See you in two weeks. Take care.

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