Investment Pitfall #4: Failing to Diversify Properly

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Keith: Welcome to episode six of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode. In today's show, we will continue our series on investment mistakes and we'll discuss one of the greatest investment pitfalls of all: not diversifying properly. We'll highlight classic diversification errors such as under diversification as well as over diversification. We'll explore what it means to diversify properly in an investment portfolio. We'll also review why it is so hard for so many investors to maintain that proper diversification over long periods of time. And finally, we'll look at the potential consequences of not diversifying properly.

Marcelo: Keith, I think before we begin, we have to mention that Shopify became the largest company in Canada. What do you think about that?

Keith: To get ahead of Royal Bank is a big feat. In the last 15 years, there's been at least four or five companies that have done it, and they haven't been able to maintain that dominance over RBC. Time will tell. We'll see how this pans out. One thing's for sure is that Shopify is a great company and a great story. And it's nice to see these stories in Canada coming from entrepreneurs that are passionate about building and building something on a global basis. Very nice to see some innovations from Canadian entrepreneurs. So, Marcelo, we spent two or three shows talking about investment mistakes. This will be the last one as we switch gears and move into planning on many different fronts. Let's again start with what is an investment mistake.

Marcelo: Sure, an investing mistake is a deliberate action which turns into a misstep that can sabotage your financial portfolio and potentially jeopardize your long-term financial security. Okay, so which ones have we covered so far? So far, we've covered not having an investment philosophy, then we moved into building portfolios based on predictions. Then we did trying to time the market and chasing performance. And today we're doing lack of proper diversification. So, Keith, why is understanding these obstacles, pitfalls, and mistakes so critical in the journey to become an empowered investor?

Keith: As we've mentioned in previous shows, becoming an empowered investor is about learning how to play the long game and staying committed to the long game. And our proposition is if you play the long game and you do it well, you will build financial security for you and your family over long periods of time. That said, anything that takes you off the long game, any distraction, any piece of noise, any pitfall that you succumb to or fall prey to can knock you off your game plan. It's critical to understand what these pitfalls look like because they sometimes are camouflaged, and investors don't necessarily see them as a pitfall, but they're a pitfall. We want to help our listeners. We want to help investors in Canada become more attuned to what they look like, how to identify them, and then how to build portfolios around them. So today's show is really focused on diversification and some of the problems and difficulties investors have with that topic. And if there's a topic that most Canadians are almost, to some degree, maybe fatigued about listening to, it might be the concept of diversification because everybody talks about it.

Marcelo: It's true.

Keith: But I'm not sure that all investors can say wholeheartedly that they're comfortable and that they really find themselves having good levels of diversification. So that's what we're going to talk about today. We'll talk about how to do that and what not good diversification looks like as well. So with that, Marcelo, what do we mean by diversification?

Marcelo: Let's start with the definition. The definition of diversification is the process of allocating capital in a way that reduces the exposure to any one company, asset class, or risk type. Now, in a portfolio management context, the strategy was discovered in the 1950s by Harry Markowitz, and it has been used successfully since then to increase returns while adding some protection to investors' outcomes. The idea behind this is that overall risk is reduced if you diversify your portfolio. I think a good example of this is we've all heard the term "do not put all your eggs in one basket," because if that basket were to drop, you would lose everything.

Keith: When I Googled "do not put all your eggs in one basket," the definition I got was, "Do not concentrate all your prospects or resources in one thing or place, or you could lose everything." That's a great definition. So what real-life examples... this is obviously an investment discussion, but Marcelo, do you have any examples of diversification in a different context other than investing?

Marcelo: University applications are a very good example because when students are graduating, it's sage advice to apply to many universities just in case. You may have the grades to get to the university where you want to, but you don't know what the selection committee will be looking for or how many applicants will be applying to that university. So it's safe to apply to three or four. I remember when I was a student, I went to my academic advisor, and she advised me to apply to three or four universities. And lo and behold, I got into two. So had I not gotten into the university I wanted to, I had a plan B. I think that's a good real-life example of how you should not put all your eggs in one basket.

Keith: That's a great example, for sure. So we're talking about Markowitz, a big name, Nobel Prize winner. What does this discovery mean for Canadian investors?

Marcelo: His discovery came out in the '50s, and essentially, it was mixing various different asset classes and securities together. Not only does it reduce the volatility of a portfolio or the risk or the ups and downs, but it gives you a slightly higher rate of return. That was the major breakthrough. I would say that most Canadians prior to the '80s or '90s weren't really saving a tremendous amount in the stock market or in buying individual companies. And so really, with the advent of mutual funds in the '80s and '90s came this idea of being able to invest in the stock market. So initially, when it first came out, people were able to buy a Canadian equity mutual fund, maybe, and maybe an international. They could maybe put together a pretty basic portfolio. The truly exciting developments that have occurred in the last 20 years with the advent of lots of new investment vehicles, in particular exchange-traded funds, index funds, and really focused strategies, individuals are able to create diversified portfolios like never before. And that is an empowerment that will resonate through with the investors.

Keith: Yeah, I think it's a great thing when you think about it. We used to be, a long time ago... and now the fact that anybody with a hundred bucks can buy a fully diversified portfolio is amazing for Canadian investors. So what does it mean to diversify properly, Keith?

Marcelo: I think you've got to sit back and go through a variety of different filters and layers. The first would be on the equity side. You have to have a diversification within companies. So you can't just own one company in your retirement account. You can't own three companies. You probably want to own more than that. And it's probably in the hundreds, if not thousands, as the right number for individual companies. You want to diversify by asset class and geographic asset class and by currency. So if you're talking on the equity side, you want to have part of your portfolio in Canadian companies, part of your portfolio in US companies, part of your portfolio in international and maybe emerging market companies. You want to diversify by sector, by industrial sector. So you want to make sure you have part of your portfolio in maybe banking, part in consumer products, part in technology, resources. There's a variety of different sectors. You want to make sure you maintain a well-diversified portfolio. You also want to diversify by asset class. Stocks, generally speaking, would be an asset class. Bonds would be an asset class. Real estate would be an asset class. So most investors, you want to have different allocations to these types of asset classes because they'll all react a little differently depending on the circumstances that an investor is in. And I guess, to me, the big takeaway when I think about diversification is every investment in a portfolio has to have a purpose. And everything, in the grand scheme of things, has to fit together like a puzzle. So there's no point in having five pieces of a puzzle. You need to have a well-meshed puzzle with lots of different pieces, but everything fits together nicely.

Marcelo: Yeah, I think about it in terms of nice art or when you see a beautiful piece of art in a room or on a wall and how it ties together the whole room. That piece has a purpose. It looks nice, but if you add, let's say, I don't know, you can have two Picassos on one wall, but it'll look too busy. So I think of diversification the same way I think about art. Every piece has to have a purpose. And it's been said, too, about diversification, that there are going to be things you're going to love and there are going to be things you're going to hate because not everything will perform amazingly when you're well-diversified.

Keith: You want asset classes that make sense over the long term, for sure, in your portfolio. I think your point is a great point. Not all asset classes perform and behave similarly at the same time. So some move forward, and some don't move forward at that time.

Marcelo: Yeah, absolutely. So, Keith, you've been an advisor for a long time. Again, I'm not calling you old. It's just you've seen a lot. Let's go through some examples of being under-diversified.

Keith: That's three times now, Marcelo, you've called me old in the last five shows.

Marcelo: It's the second, and I'll stop.

Keith: That's okay. Don't worry. It's all good. So, yeah, listen, there are some classic concentration stories that I think everybody has seen. A few that come to mind: in the 2001 to 2004 zone, we used to see a lot of portfolios coming in with five, six, seven, eight companies, a lot of technology companies. Technology was having a hard time at that time. Fast forward three or four years, I remember retirees walking in, and they had three securities. That was their entire portfolio. It was three oil and gas income trusts, and it was yielding about an 11% distribution, but they didn't see an issue with it. I reminded them that this is not a diversified portfolio. And that was the norm back then. In 2007, it was very hard to find Canadian investors with any real allocations to US companies or diversified US positions. The US had just gone through a period called the last decade. That last decade was even more difficult for a Canadian investor investing in US companies because they had the currency. Not only was the stock performance difficult, but the currency was moving against them. We would find a lot of stories where clients or individuals weren't diversified. The theme continues. You find investors with maybe their favorite sectors, and they overweight them, or dividend-only companies from certain sectors. And they tend to not be well-diversified, and that works well as long as it works. And then when it doesn't work, all of a sudden it doesn't work. That's when you sit back and say, "I'd rather have a diversified portfolio."

Marcelo: That's a big one in Canada, the dividend. I think I used to be subscribed to, and we know, a lot of people know, MoneySense, and they always have these articles about three dividend stocks you'll never regret having. And I think this is a big theme. Did you see this a lot with your clients?

Keith: You know, it wasn't so much with the clients, but you'd see all the general investors at large doing all sorts of different things. I remember vividly there was this theme around, depending on the Canadian city you lived in, you might see more securities of a certain nature. So, for example, in Montreal in and around 2000-2003, you would see a lot of holders of Northern Telecom, a lot of holders of Bombardier. And in Calgary, you know what you're going to see in Calgary. We would see tremendously concentrated portfolios in oil and gas. In Ottawa, in and around that period, there were a lot of small technology companies. So it was not unusual to see an Ottawa-based portfolio with 50% of their holdings in three technology companies. It's just an interesting thing that we were seeing in Canadian cities, which I remember being odd and definitely not being a well-diversified portfolio. What about you, Marcelo? What have you seen in your last few years as an advisor?

Marcelo: I've seen a few bad ones, but I think the one that really struck me the most was we onboarded a client last year. She's a 70-year-old lady, and her portfolio, it almost stunned me because her allocation was 80% to equities, Canadian equity. So 80% was invested in Canadian equities. And when you broke down the sectors, 50% was invested in financial services, and 30% was invested in energy companies, which are two of the most dominating sectors in Canada. But what struck me the most is how stressed and anxious she was every time she had to sell a position to generate income just to go through her retirement. So that was one of the worst examples that I've seen of under-diversification.

Keith: And now that she's diversified, does she feel better?

Marcelo: Yeah. We're trying to reach out to all clients just to see how they are doing during this coronavirus. And I didn't even ask her specifically about the portfolio, but she threw a line in there that really stuck with me and said, "Moving all the assets and having a well-defined process really reduced the anxiety, and now she's happy that part of her life is solved." That's nice to see.

Keith: Oh, that's great to see. So we just spent a few minutes talking about concentrated portfolios, and I think that's one of the big faux pas within this concept of diversification. Marcelo, have you seen any examples of over-diversification? What does that look like?

Marcelo: I think I have an example that just really takes the trophy because we've seen a lot of bad ones, a lot of collection of mutual funds. But last year we met a prospect that had 28 different mutual funds. What struck us the most when we started to dissect the portfolio was, one, the amount of funds and the things in the portfolio. So you would have target date funds, which are typically found in a work retirement program. We would find things like high-income funds. We would find things like global balance funds. We would find energy funds. So if you think about the art example, it's a lot of nice art pieces on a wall. So nothing had a purpose. It was like just a random collection of mutual funds. And a lot of people would look at that and say that's diversification. You have a lot of exposure there, but it just didn't work.

Keith: Yeah, that was a really big theme a while back where individuals felt like they had to own a lot of mutual funds, and then they had to diversify across a lot of institutions. I think they had the feeling that they were diversified. The problem with that was there was just a tremendous amount of overlap. And if you would ask the person, "What's your strategy? What's your philosophy? What's your total asset allocation? What's your total sector exposure?" there's no way they could answer that. That's not great. So that's a great example of over-diversification.

Marcelo: Yes, it is. But let me ask you something. Why do you think investors end up in situations like that?

Keith: You mean being either over or under-diversified? Let's talk about being under-diversified. I think investors get attracted to stories. It's back to the stories and the narratives, and it looks like the world is moving this way, so therefore, let me concentrate. It looks like a sector is moving this way, so let me heavily concentrate. And at the end, unfortunately, I think investors are humans, and humans have emotions. And deep down inside, we have emotions of fear, we have emotions of greed. When we're worried and scared, we do things, and when we think we can make a boatload of money, we try to do things. I recall even helping investors maybe 15-20 years ago, they'd come in and I'd say, "Okay, here, build this portfolio using these exchange-traded funds." It would be pretty straightforward—be a quarter fixed income, a quarter Canadian equity, a quarter US equity, a quarter international. "Come and see me in three years." And then they'd come back and they would see me in three years, and I'd say, "What did you do with the US equity? It's not there anymore." Of course, the narrative comes in, "Well, the United States isn't doing well." This would have been around 2006-2007, right at the end of their last decade, their performance was lagging. Canadian stocks are doing so well. I just figured I would take money out of my US allocation and load up in Canadian equity. And so there's a perfect example of how you become undiversified. You start off with a plan, and then your emotions get in the way, the narratives get in the way, the stories get in the way, and then you almost become unhinged and undiversified. Marcelo, we're talking here about diversification, both under-diversification and over-diversification. Let's talk about risk management for a second here. We've heard this term pop up recently with regards to our circumstances that we're in. We've heard the term "black swan." Let's talk a little bit about whether we're in a black swan, but before we even get there, what is a black swan? Who defined it from an investment perspective, and then how did they come up with that name?

Marcelo: The term was coined by Nassim Taleb, who wrote the book "The Black Swan." For him to be considered a black swan, you have to have three things. The first one is the event has to be unpredictable. Two, it has to carry a massive impact. And three, after the fact, we will build an explanation that makes it appear less random. The term actually comes from back in the day, people used to think that all swans were white because that's all you used to see. So up until the day that one person saw a black swan, and his perspective really changed. So the term comes from them, but in investing, it's more what Nassim Taleb coined as the black swan, which is the three things that I just listed. That's his definition.

Keith: Yes, okay. So we'll get to whether we're in a black swan now in a sec, but give us an example of what Taleb calls a black swan, a true example.

Marcelo: We've had a lot of black swan events throughout history, but I think one that most people can remember is the events of 9/11. If you think about that, Keith, in September 10, 2001, there's not one person on earth that would have predicted that two planes were gonna act like missiles and go into the Twin Towers, right? And then again, it had a massive impact. It was unpredictable. And then after the fact, you had all sorts of explanations. So I've heard the explanation many times. People reason and say, "Oh, it was obvious that was going to happen because the US was arming rebels back in Afghanistan when they were fighting the Russians, so it was bound to happen." So you had all these reasonable explanations that fit all three requirements of a black swan. Then there's a really good analogy in the book. And again, I encourage everybody to read the book. It's a great book. But he talks about the idea of the turkey and the farmer. The turkey will get the idea and reinforce the idea every day...

Keith: So hang on, you're talking about as if you're a turkey here.

Marcelo: Yeah, so it's an analogy, obviously. But he says, you know, you have a turkey, and the farmer will feed the turkey every day, reinforcing the idea that it's his friend, that it's taking care of him. So the turkey will think, "Oh my god, the human is my friend," right up until the Wednesday before Thanksgiving, where he gets laid and then cooked. So that is a black swan event. That day, everything changes for the turkey, and that's it.

Keith: Yeah, so the black swan event there, the turkey had the black swan event. Yes, I gotcha. I gotcha. So we have the coronavirus. We obviously have serious issues in the economy. We have serious issues in companies. Investors have to deal with this. Is this a black swan from an investment perspective?

Marcelo: I would say no, and even Taleb says no, because it doesn't fit the description of a black swan because it was not unpredictable. There's been so many warning signs about this. I'm going to mention three. So Nassim Taleb in 2007 came on record and said that was the next big risk in the world, just in the way the world was interconnected. Then Bill Gates in 2015 had a really good TED Talk about this. Anybody can go check that out. And then David Quammen is a very famous author. He wrote a book in 2012, and the main thesis of the book is because now we're reducing ecosystems for animals, all these viruses are going to find new hosts. And it was just a matter of time that we would have a pandemic. There's even more people than that who raised the warning flags, but definitely it's been there. So it's not a black swan.

Keith: Okay, so with regards to black swans, what's the importance of diversification?

Marcelo: The importance is because surprises happen. These events are highly unpredictable. And if you're well-diversified and properly diversified, you reduce the risk in your portfolio. Again, if you have all your eggs in one basket and that one's the basket that ends up breaking because of the event, you'll be sorry. It's an antidote. All of these events, surprises, unexpected events, whether they're a black swan or not, diversification can help. It helps in protecting your capital. It helps in making sure that all your eggs are not in a single basket, and it helps with regards to your exposure. What are the consequences of not diversifying properly, Keith?

Keith: I think they're the same consequences as some of the previous pitfalls that we spoke about. They're really two dimensions to it. The first is that by not doing proper diversification, you run the risk of reducing your returns. You run the risk of lower returns, and that is material. You run the risk of not reaching your retirement goals financially because your portfolio takes a negative turn. That's the big one. The second big one, I think, is you increase your investor's level of anxiety. You start worrying about, "My goodness, I'm having this impact on my portfolio." The default is worry, concern, frustration. We've coined it before. It's a double negative. You end up with worse returns in your portfolio and worse feelings around where you're going. You don't feel as if you're in control. So it is a double negative, and that's not great. That's why we think it's so important to address.

Marcelo: So, Marcelo, we're wrapping the show up. Let's talk about a couple takeaways. What's your takeaway for the show?

Marcelo: My takeaway is simple. Surprises happen. Life is unpredictable, and you want to be diversified. It's the way that you'll protect yourself against these surprises. And again, you're going to love some stuff in your portfolio, you're going to hate some stuff, but overall, when bad things happen, you'll be happy that you're diversified.

Keith: Awesome. That's a great takeaway. Mine would be to make sure that when you're thinking about diversification, think of a puzzle. Think of all the pieces in your portfolio that have to fit together nicely like a puzzle. And if you can get to that point, then you have a well-diversified portfolio.

Marcelo: I couldn't agree more. What's in store for our next episode?

Keith: Our next episode, we're going to start migrating into planning concepts, planning for retirement, cash flow planning, and introduce our listeners and Canadians to the do's and don'ts around planning. So thanks for tuning in, everybody. Be well, be healthy, and we look forward to seeing you in two weeks from now. Thank you, everybody.

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