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IN THIS ISSUE

Over-diversification, or "di-worse-ification," can dilute investment returns and increase costs without reducing risk. Maintaining a focused portfolio of high-conviction assets is often more effective than holding numerous overlapping investments.

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DIVERSIFY OR DI-WORSE-IFY?

THE FINE LINE BETWEEN SMART STRATEGY AND RISKY OVERLOAD

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What happens when an investor tries to diversify too much? They end up with a portfolio that is too complicated and too difficult to manage.

When it comes to investing, the mantra "diversify" is often hailed as one of the most essential rules for protecting a portfolio and achieving long-term financial success. But as with most things in life, moderation is key.

While diversification is a powerful tool in risk management, there is a point where spreading your investments too thin can lead to, what some call, "di-worse-ification" – a phenomenon where attempts to reduce risk actually end up reducing the potential for returns. In other words, making your outcome worse, not better.

In this article, we explore the concept of diversification, the potential pitfalls of over-diversification, and how to strike the right balance in your investment strategy.

NOT EVERY INVESTMENT OPPORTUNITY IS RIGHT FOR YOUR PORTFOLIO. KNOW WHEN TO BE CAUTIOUS IN YOUR STRATEGY.

WHAT IS DIVERSIFICATION?

In simple terms, diversification is the practice of spreading your investments across various asset classes, industries, geographical regions and other factors, to reduce exposure to any single risk. The idea is that by holding a mix of assets – some of which may perform well when others are struggling – you can smooth out the ups and downs of your portfolio and reduce overall volatility.

For example, if you invest in a combination of stocks, bonds, real estate and commodities, the performance of these assets will often be uncorrelated. When one market is down, another may be up, protecting your portfolio from major losses.

THE BENEFITS OF DIVERSIFICATION

1

Reduced risk:
By holding a variety of investments, the risk of any single investment dramatically impacting your portfolio is minimised.

2

Better long-term returns:
Diversified portfolios tend to deliver smoother returns over time, helping investors stay the course during market fluctuations.

3

Exposure to different markets:
By diversifying across different asset classes, industries and geographical regions, investors gain exposure to a wide range of opportunities, which could lead to higher returns in the long run.

BUT BEWARE: DI-WORSE-IFICATION

The term "di-worse-ification" is often used to describe what happens when an investor tries to diversify too much – so much so that they dilute the potential for higher returns, making the portfolio overly complex or inefficient. In essence, the goal of diversification shifts from risk management to simply having a portfolio that is too broad, with assets that don't meaningfully contribute to long-term growth.

HERE ARE SOME OF THE KEY SIGNS OF DI-WORSE-IFICATION:

1. TOO MANY HOLDINGS

While diversification requires a mix of assets, there is no need to own every stock or bond under the sun. Having too many holdings can lead to a portfolio that is overly complicated and difficult to manage. The more assets you add, the less each individual investment can impact the performance of your overall portfolio.

Pitfall: The more assets you own, the more time you'll spend managing them. Plus, many of these investments may not add much value to your overall return. Instead of focusing on the best opportunities, you could be weighed down by assets that are underperforming or redundant.

2. OVER-DIVERSIFICATION ACROSS SIMILAR ASSETS

Adding too many similar assets to a portfolio can water down its overall performance. For example, owning 15 different tech stocks in various regions is still concentrated in one sector – technology. If tech stocks are down, it doesn't matter how many of them you own, your portfolio will suffer the same fate.

Pitfall: Over-diversifying within the same sector or asset class can lead to a lack of meaningful diversification. It is essential to ensure you are diversifying across different sectors, regions and asset classes (stocks, bonds, real estate, etc.) rather than just adding more of the same.

3. FOCUSING ON TOO MANY ASSET CLASSES

Another common mistake is trying to diversify across too many different asset classes. While it is important to have a range of investments, putting your money in every possible asset class – from stocks and bonds to real estate and even cryptocurrencies – could end up being counterproductive.

Pitfall: Some asset classes may have little to no correlation with each other, or they may not fit into your long-term financial goals. For instance, cryptocurrency is highly volatile and speculative, so putting a large portion of your portfolio into it may not be wise, especially if you're trying to build a balanced, long-term investment strategy.

4. CHASING AFTER EVERY NEW TREND

New investment products, sectors and markets can be tempting to jump into, but blindly following these trends can lead to di-worse-ification. Just because something is new, or trending, does not mean it's the right fit for your portfolio.

Pitfall: Trying to capitalise on every trend can leave your portfolio fragmented, leading to poor risk management and potentially significant losses. This is especially true if you're chasing after "hot" investments that may not align with your risk tolerance or long-term financial goals.

FINDING THE SWEET SPOT: DIVERSIFICATION WITHOUT DI-WORSE-IFICATION

So, how do you diversify your portfolio without falling into the trap of di-worse-ification? Here are a few strategies to help you strike the right balance:

QUALITY OVER QUANTITY:
Focus on a limited number of high-quality investments rather than trying to own everything. This ensures that each asset makes a meaningful contribution to your portfolio's overall performance.

FOCUS ON ASSET CLASSES AND SECTORS, NOT JUST THE NUMBER OF ASSETS:
Aim for diversification across asset classes, such as stocks, bonds, real estate and alternative investments, as well as different sectors and geographical regions.

PERIODIC REBALANCING:
Regularly review and rebalance your portfolio to ensure it aligns with your goals and risk tolerance. Rebalancing also helps prevent overexposure to any one asset class or sector.

STAY TRUE TO YOUR RISK PROFILE:
Diversification should help manage risk, but it should still align with your investment goals. Avoid making drastic changes to your portfolio based on short-term trends or fads that don't fit your overall strategy.

DON'T BE AFRAID TO SAY NO:
Not every investment opportunity is right for your portfolio. Be discerning and know when to pass on assets that may overcomplicate your strategy or expose you to unnecessary risk.

CONCLUSION: STRIKING THE BALANCE

Diversification remains one of the cornerstones of smart investing, but like all strategies, it must be used wisely. Spreading your investments across various asset classes, sectors and regions can reduce risk and provide smoother returns over time. However, over-diversification – di-worse-ification – can dilute potential returns and complicate your portfolio beyond necessity.

By focusing on high-quality assets, maintaining a balanced allocation and periodically rebalancing your portfolio, you can achieve diversification without the risks associated with di-worse-ification. Remember, it's not about how many investments you own; it's about how well they work together to help you achieve your financial goals.

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I joined the Brenthurst Wealth team in April 2021 as a Financial Advisor under direct supervision . I obtained my BCom (Hons) in Management Accounting from the University of South Africa (UNISA) and have been working in the finance industry for over 10 years. I am registered with SAIPA as a Professional Accountant and Tax Practitioner. I completed my Class of Business and Postgraduate Diploma in Financial Planning through the University of the Free State. I am a CERTIFIED FINANCIAL PLANNER® professional, a member of the Financial Planning Institute of SA and am fully qualified to give advice on all investment matters.

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