How Do You Know if Your Assets are Diversified?

Using statistical correlations can help refine your investments and lower risk

The turmoil in the markets in the first few months of 2022 has demonstrated the benefits of diversifying your assets. Stocks plunged in January and February, rebounded in March, but are still negative YTD. And the bond market suffered its worst quarter since 1980.

So, how do you figure out how well your asset mix is diversified, and not too heavy in one area – like stocks?

Seasoned investors are used to spreading risk across multiple investments, such as stocks, bonds and commodities. Professionals, however, take it a step further: measuring "correlations."

1.1.1 Understanding Correlations

Without getting too technical, assets with a correlation of +1 move exactly the same in response to market developments. That would be painful to a portfolio if bad news prompted all the assets to fall in tandem. Assets with a correlation of -1 move in opposite directions. This, too, poses problems by curbing a portfolio's gains in response to good news.

The preferred correlation: anything less than 1. That's when the benefits of diversification are more likely to kick in. For example, a portfolio with two securities with a correlation of 0.72 will move in the same direction. Both may fall in a market downturn, but one might not fall as far.

1.1.2 Knowing Market Risks

Remember that market risk is always present. It comes in all forms: accounting risk, business risk, country risk, default risk, financial risk; and government risk.

What would have happened if you had invested solely in junk bonds or bitcoin or only in a single stock? Diversification only minimizes risk. Using statistical correlation allows you to refine your investment selections to lower risk even further.

1.1.3 Refining Diversification

Smart diversification should be the goal of every investor. Yes, it's true that generally speaking, the more securities you add to a portfolio, the lower the risk. But that is only true up to a certain point.

Another caveat: Proper diversification limits a portfolio's gains in a bull market. If the S&P 500 increases 30% next year, don't expect the same from a diversified portfolio. That's tough to deal with when the stock market is surging. On the other hand, the same portfolio won't likely mirror a 30% drop in the S&P 500 – a welcome tradeoff for many investors.