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Strategies

Yes, diversification works - eventually

When everything's going down, spreading your bets might seem pointless. But over the long term, it still pays.

By William J. Bernstein, Money Magazine

(Money Magazine) -- It's one of the first things you learn about stock investing: Diversification reduces your risk. U.S. blue chips, foreign stocks, small-caps, and real estate investment trusts may each have their risks, but they won't all go down at once ... right?

In fact, sometimes they do just that. This market collapse has convinced many investors that stock diversification doesn't work. Blue chips and small-caps are down more than 38% over the past 12 months. International markets have lost about half their value, and so have REITs. The only place to hide has been in Treasuries.

But before you give up on the idea of diversification, consider the alternatives. There are only two, and neither one is great.

Option 1: "Put all your eggs in one basket - and watch that basket." Mark Twain wrote that in 1894. It may seem like relevant advice today as many investors wonder what the heck happened to their diversification plays.

Look at foreign-stock mutual funds, which sold briskly in the run-up to the crash. Though their red-hot returns didn't hurt, the sales pitch emphasized how they would zig when the U.S. zagged. But if foreign stocks fall at least as much in a crash as U.S. stocks, why not just stick to investing at home? After all, you know a thing or two about the American market. It's an easier basket to watch.

Not all market crashes will be like this one, though. Sometimes the disasters are local.

Put yourself in the position of a Japanese investor 20 years ago. If you didn't diversify beyond your own market, you would have lost 2.5% a year since then, while stocks worldwide grew 4.9% annually.

Hedging against such catastrophes - however unlikely - is the best reason to diversify.
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Within the U.S. stock market, stock diversification also has a better track record than recent experience suggests.

Take a look at the 2000-02 downturn. Before that debacle, all anybody wanted were tech stocks and the world's largest growth companies. REITs languished because the Internet was making bricks and mortar obsolete. Small banking, manufacturing, and retail concerns? Toast in the new economy.

But those were the stocks that made money when the S&P 500 took its dive.

Option 2: "If you can't stand the heat, get out of the kitchen." That was said by Harry Truman, of course. For an investor, it might mean that when stocks look risky, you should cash out.

But it won't work.

Imagine it's late 1998, and a little bird tells you that there will be not one, but two historic meltdowns over the next decade. So you do the sensible thing and sell your stocks.

Amazingly, that might not have done you much good. Over the next decade, a portfolio evenly split among the basic stock categories - growth and value U.S. blue chips, U.S. small-caps, a parallel lineup of investments in developed foreign markets, REITs, and emerging markets - would still beat Treasury bills.

And this example uses the best imaginable scenario for market timing. We're not usually visited by small, prescient avians.

Investment wisdom begins with the realization that it's the decades, not the days, that matter. And over the long term, diversification really does protect your portfolio.

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