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Diversification: Building a Portfolio that can Dampen the Impact of a Volatile World

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"Diversification is the only free lunch in investing." – Harry Markowitz

Introduction

It's a simple idea: don't put all your eggs in one basket. And yet, diversification remains one of the most misunderstood—and underutilized—principles in investing. For some, it just means owning a few different stocks. For others, it's a vague buzzword. But in practice, diversification is one of the most powerful tools investors have to manage risk and improve the odds of long-term success.

In this paper, we'll clarify what diversification really means, how it differs from asset allocation, and what modern research says about how much diversification is enough. We'll also look at why mutual funds and ETFs are often the best tools for the job, and whether alternatives like commodities and private equity are worth considering.

What Is Diversification?

Diversification is the practice of spreading your investments across a variety of holdings so that no single asset, sector, or risk source dominates your portfolio. The goal isn't to eliminate risk altogether—that's impossible—but rather to reduce *unsystematic* risk: the kind tied to specific companies, sectors, or countries. There's an old adage on Wall Street: **"***You don't get paid for risks that can be diversified away***."** In other words, the market only compensates investors for bearing *systematic risk*—the kind you can't avoid, like overall market volatility. But *unsystematic risk*—the risk tied to individual stocks, sectors, or companies—can be reduced or eliminated through diversification. If you choose not to diversify, you're taking on extra risk without any expectation of higher return. That's not bold—it's inefficient.

Consider a portfolio made up entirely of airline stocks. If oil prices surge or travel demand drops, the entire portfolio takes a hit. But if those same holdings are just one part of a broader mix—including healthcare, consumer staples, technology, and fixed income—then the damage is contained.

Diversification doesn't guarantee gains or prevent losses, but it does smooth out the ride. And when markets get choppy, that's often what keeps investors on track.

How Is Diversification Different from Asset Allocation?

Though often confused, asset allocation and diversification refer to different layers of portfolio construction:

- Asset allocation is about what kinds of assets you own—stocks vs. bonds, U.S. vs. international, public vs. private.
- Diversification is about how much variety you hold within and across those categories.

Think of asset allocation as the blueprint of your investment house. Diversification is the way you furnish each room—carefully, with multiple pieces, so that no single item carries the whole load.

A truly resilient portfolio has both: a thoughtfully chosen asset allocation and broad diversification within each asset class.

How Much Diversification Is Enough?

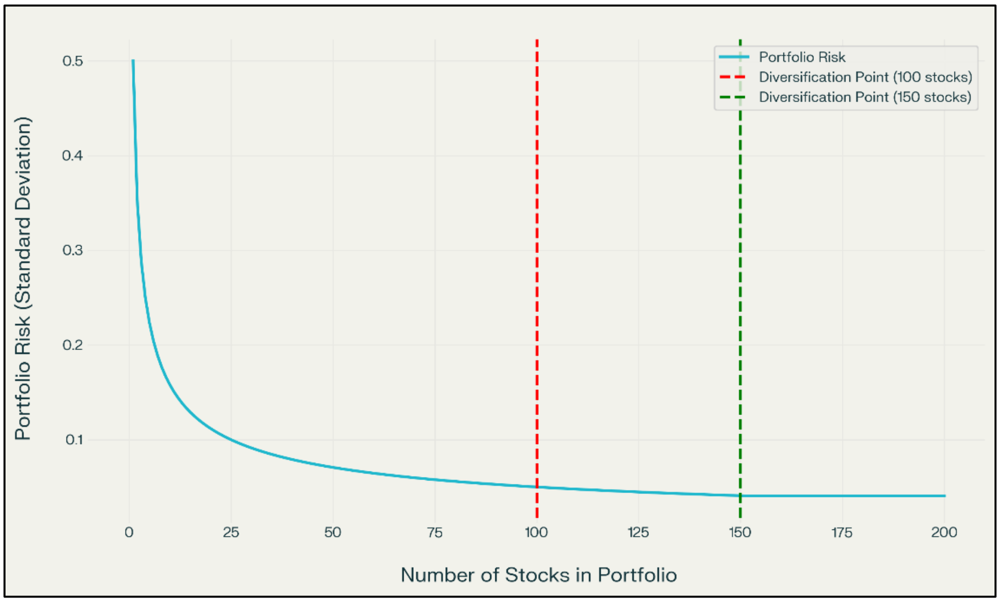
For years, the conventional wisdom was that owning 15 to 30 stocks was sufficient to diversify away most company-specific risk. That view was supported by studies like Evans and Archer (1968), which showed diminishing volatility as portfolio size increased.

But more recent research tells a more complex story.

A 2021 review published in *MDPI* by Zaimovic, Omanovic, and Arnaut-Berilo found that due to globalization, market integration, and increased sector-specific risks, the number of stocks needed for effective diversification has risen. What was sufficient 50 years ago may no longer apply today.

A separate study by Alexeev and Tapon (2013), published by the University of Tasmania, found that investors may need to hold 100 or more stocks to reduce diversifiable risk by 90%, especially in volatile or concentrated markets.

And there's another problem: return concentration. Research by Hendrik Bessembinder (Arizona State University) showed that since 1926, just 4% of U.S. stocks accounted for all the net wealth created in the stock market. That means holding a small portfolio increases your risk of missing the rare long-term winners.



Source: Investopedia

A line graph illustrating how portfolio risk declines as the number of stocks increases. The curve flattens after roughly 100–150 holdings, indicating the point of meaningful diversification.

Why Mutual Funds and ETFs Can Help

Most individual investors don't have the time, capital, or tools to research and manage portfolios with hundreds of stocks and bonds. That's where mutual funds and ETFs come in.

For example:

- Vanguard Total Stock Market ETF (VTI) gives exposure to over 3,500 U.S. stocks.

- iShares MSCI ACWI ex U.S. ETF (ACWX) offers access to more than 2,000 international companies.
- iShares Core U.S. Aggregate Bond ETF (AGG) holds a diversified portfolio of more than 3,000 investment-grade bonds.

With a single purchase, these funds allow investors to own thousands of securities—across sectors, geographies, and asset classes. That kind of diversification would be nearly impossible to replicate individually.

Do You Need Alternatives to Be Diversified?

What about commodities, private equity, real estate, or hedge funds?

Alternative investments can add diversification benefits because they often behave differently than traditional stocks and bonds. But they also introduce new risks:

- **Liquidity risk** – Some investments, like private equity, lock up your capital for years.
- **Transparency** – Hedge funds and private deals often offer less information and oversight.
- **High fees** – Many alternatives come with steep costs that erode returns.
- **Complexity** – Strategies can be opaque and difficult to evaluate.

For most individual investors, broad exposure to public global stocks and bonds provides sufficient diversification. Alternatives can play a role, but they should be used selectively—and only when the investor fully understands the trade-offs.

Behavioral Benefits: Staying the Course

Diversification isn't just a mathematical concept. It's a behavioral one.

We diversify because we don't know what the future holds. Diversification is a quiet act of humility—a recognition that even the smartest investor can't predict which asset, sector, or region will outperform next.

When your portfolio is diversified, no single investment dominates your results. That helps reduce the emotional swings that lead many investors to make poor decisions—like panic selling after a market drop.

And remember, a well-diversified portfolio won't have all its parts moving in the same direction at once. If every investment is rising together, you may not be as diversified as you think.

By smoothing the ride, diversification helps you stick to your plan. And staying invested—through all market conditions—is one of the most powerful drivers of long-term success.

Points to Remember

- Diversification spreads risk across different holdings, reducing the impact of any one asset's poor performance.
- It complements asset allocation, which determines the types of investments you hold.
- You don't get paid for risks that can be diversified away.
- New research suggests 100+ stocks may be needed to fully capture diversification benefits—far more than most individuals can manage on their own.
- Mutual funds and ETFs offer broad, cost-effective access to thousands of securities, making them ideal vehicles for diversified investing.
- Alternatives can help, but they come with added complexity and risk—and aren't necessary for everyone.
- Perhaps most importantly, diversification helps you stay invested through the ups and downs, which can help compound returns over time.

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