Dimensional

OUTSIDE THE FLAGS

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Gravel Road Investing

Owners of all-purpose motor vehicles often appreciate their cars most when they leave smooth city freeways for rough gravel country roads. In investment, highly diversified portfolios can provide similar reassurance.

In blue skies and open highways, flimsy city sedans might cruise along just as well as sturdier sports utility vehicles. But the real test of the vehicle occurs when the road and weather conditions deteriorate.

That's why people who travel through different terrains often invest in a SUV that can accommodate a range of environments, but without sacrificing too much in fuel economy, efficiency and performance.

Structuring an appropriate portfolio involves similar decisions. You need an allocation that can withstand a range of investment climates while being mindful of fees and taxes.

When certain sectors or stocks are performing strongly, it can be tempting to chase returns in one area. But if the underlying conditions deteriorate, you can end up like a motorist with a flat on a desert road and without a spare.

Likewise, when the market performs badly, the temptation might be to hunker down completely. But if the investment skies brighten and the roads improve, you can risk missing out on better returns elsewhere.

One common solution is to shift strategies according to the climate. But this is a tough, and potentially costly, challenge. It is the equivalent of keeping two cars in the garage when you only need one. You're paying double the insurance, double the registration and double the upkeep costs.

An alternative is to build a single diversified portfolio. That means spreading risk in a way that helps ensure your portfolio captures what global markets have to offer while reducing unnecessary risks. In any one period, some parts of the portfolio will do well. Others will do poorly. You can't predict which. But that is the point of diversification.

Now, it is important to remember that you can never completely remove risk in any investment. Even a well-diversified portfolio is not bulletproof. We saw that in 2008-09 when there were broad losses in markets.

But you can still work to minimise risks you don't need to take. These include exposing your portfolio unduly to the influences of individual stocks or sectors or countries or relying on the luck of the draw.

An example is those people who made big bets on mining stocks in recent years or on technology stocks in the late 1990s. These concentrated bets might pay off for a little while, but it is hard to build a consistent strategy out of them. And those fads aren't free. It's hard to get your timing right and it can be costly if you're buying and selling in a hurry.

By contrast, owning a diversified portfolio is like having an all-weather, all-roads, fuel-efficient vehicle in your garage. This way you're smoothing out some of the bumps in the road and taking out the guesswork.

Because you can never be sure which markets will outperform from year to year, diversification increases the reliability of the outcomes and helps you capture what the global markets have to offer.

Add discipline and efficient implementation to the mix and you get a structured solution that is both low-cost and tax-efficient.

Just as expert engineers can design fuel-efficient vehicles for all conditions, astute financial advisors know how to construct globally diversified portfolios to help you capture what the markets offer in an efficient way while reducing the influence of random forces.

There will be rough roads ahead, for sure. But with the right investment vehicle, the ride will be a more comfortable one.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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