TD Wealth

Portfolio Insights

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Report prepared by:

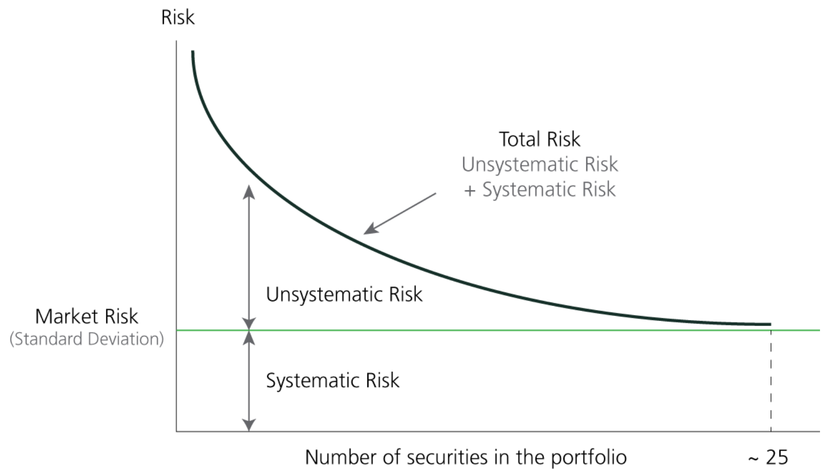
Yogesh Oza, CFA
North American Equities

The Importance of Portfolio Diversification

While it may be tempting to significantly overweight a favourite stock or sector, it is important to remember that by maintaining a properly diversified portfolio, investors are better able to navigate the inevitable twists and turns on the road towards their financial goals. Diversification is a crucial tool to manage risk in an investment portfolio.

The first step to achieving your financial goal is to develop a strategic asset allocation (SAA). The SAA is specific to each investor and defines an appropriate mix of equities, fixed income, cash and other asset classes. While it is essential to have appropriate diversification within each component of the SAA, this article focuses on the importance of appropriate diversification in the equity allocation of the overall portfolio.

Chart 1: How Many Stocks Are Required For Diversification?



Source: Portfolio Advice & Investment Research

We suggest that roughly 25 to 30 stocks are required for a well-diversified equity portfolio. By holding a sufficient number of equities, investors can significantly reduce unsystematic risk—the risk specific to a stock or industry for which investors are not compensated. Examples of unsystematic risk include the risk of an energy company not receiving environmental permitting, labour disruptions, or supply-chain issues. Once this is accomplished, systematic risk remains; this is defined as a pervasive risk that is inherent in markets, such as business-cycle and liquidity risks. During the great recession for example, stocks ranging from mining to utilities came under pressure to varying degrees as the global economic outlook deteriorated.

In building an equity portfolio, an investor should consider selecting securities that vary in terms of sector, geographic location, and other characteristics such as specific macro drivers or perhaps market capitalization, in order to reduce the correlations between the holdings. During different phases of the market cycle, equities with specific characteristics could outperform. For example: a Canadian small-cap copper miner might come under pressure as a result of softening global growth expectations while a large-cap U.S. health care company would likely be more insulated from such concerns.

Utilizing professionally managed solutions can also play an important role in achieving sufficient diversification. Investors who would prefer not to construct and monitor the individual equity holdings in a portfolio can instead opt to hold a well-diversified mutual fund, exchange traded fund, or managed portfolio (separately managed account). Managed solutions can also be used to complement a core portfolio whereby the investor would select the appropriate investment funds in order to get exposure to niche areas, such as emerging markets.

While it is important to have a sufficient number of stocks to achieve diversification, over-diversification can also result in sub-par outcomes. A portfolio that is unwieldy and contains a large number of stocks could also pose its own risks—the risk of not only underperforming broader markets due to a lack of focus, but also the risk of not being able to effectively monitor the portfolio holdings over time.

In today's complex global financial markets, it is as important as ever to establish a well-diversified portfolio that reflects your return objectives, constraints, and risk tolerance. By maintaining a diversified portfolio, an investor will be better able to weather the inevitable bumps in financial markets and remain focused on achieving their longer-term goals.

Appendix A – Important Information

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