A Good Idea is Good; Lots of Ideas are Better

The importance of diversification is familiar to any investor. Don't put all your eggs in one basket, right? A Nobel Prize was awarded in 1990 to a local semi-retired guy named Harry Markowitz for adding some rigor to the concept. If I decide to buy some large-cap stocks, I will have better odds of success if I buy a large number of such stocks rather than only buy a few.

Most investors view diversification in only one dimension. They understand owning many stocks. They even understand owning different types of stocks. But, this is not enough. There is a more subtle form of diversification that is necessary to further improve the odds of success.

I refer to this wider dimension as *idea diversification*.

When constructing a portfolio, we usually have a particular outlook in mind – whether we consciously state it or not. We might, for example, expect stocks to provide a nice return over time. So, we set out to buy some stocks. Keeping diversification in mind, we buy big stocks, small stocks, foreign stocks and stocks of various styles such as value and growth. We do this by either selecting the stocks ourselves or by choosing multiple mutual funds or other professional stock pickers. The result is a highly diversified stock portfolio with exposure to all industries, sectors and styles.

The only problem with this beautiful portfolio is that it is built entirely on the foundation of *one single investment idea*: an outlook for stocks. If stocks deliver a disappointing return, the entire portfolio will be disappointing. The fact of the matter is that all of the different styles and flavors of stocks actually behave similarly from period to period. This similarity is called *correlation*. While we like to think of value and growth stocks as two different things, they actually have a correlation of 77%. A correlation of 100% means two things behave exactly alike; a correlation of minus 100% means they behave in exactly opposite ways. A correlation of 77% is quite high, meaning that value and growth stocks are nearly the same thing. *They are two expressions of the same investment idea.*

Investors get into trouble when they put all their eggs in one basket. If the only basket is stocks, then all the diversification in the world across stock styles will not save you from a stock market problem. Foreign stocks have a correlation to U.S. stocks of 78%. Large and small cap stocks are 83% correlated.

When constructing a portfolio, it is a good idea to include several investment ideas that are not directly correlated to each other. Bonds and stocks have a modestly low correlation to each other. Real estate has only a 23% correlation to stocks. Foreign bonds are only 0.09% correlated to domestic stocks. I am not suggesting that you go out and blindly buy these asset classes. You still need to develop an outlook regarding whether you think they will or will not provide good returns.

In my practice, I develop a number of different outlooks. Let's imagine my outlook is for a pickup in economic growth. That is *one* investment idea. If I implement that idea by buying stocks and selling bonds, I still only have one idea in my portfolio. I expressed it in *two* different ways – and I am really *not diversified*. I still need to generate some more ideas. Maybe I can develop an outlook for currencies, or for trade flows, or for a particular industry. Of course, the ideas have to be good ones, with good research and cautious, informed conclusions.

People occasionally ask me for a Monday-morning quarterback opinion about the collapse of Long Term Capital Management, the infamous hedge fund. Long Term Capital collapsed in 1998 after taking colossal positions in various bonds. In the news stories of the time, the company's executives seemed to be saying, "But we diversified ourselves with many different positions and investments. This shouldn't have happened." In hindsight, we know that what Long Term Capital really did was express one single investment idea – *price convergence* – in dozens of different ways, with gigantic amounts of leverage. When convergence turned into divergence, it did so across all of Long Term Capital's biggest bets. Its investors lost billions in a matter of weeks.

Different flavors of stocks are not enough to ensure a diversified portfolio. Investors are wise to consider alternatives such as domestic and foreign bonds, high-yield bonds, real estate, and even hedge funds or managed futures. Challenge your own thinking, and develop more than one investment idea. The diversification of ideas is essential to your investment success.

