When Is It Good to Be A Naïve Investor?

Mark Henricks Nov 19, 2015 4:29 PM EST

Naïveté is not normally considered a positive, especially in a take-no-prisoners world like Wall Street. However, an investment portfolio-building approach called “naïve diversification” -- also called the “1/N portfolio strategy” -- is simple, cheap and easy enough for any retirement saver to do it.

Naïve diversification is straightforward and intuitive. You take the number of asset classes or individual investments you plan to invest in and divide it into 1 to get the percentage of your portfolio that will go into each asset class.

Say you are going to invest in three asset classes: stocks, bonds and real estate. Dividing one by three gives 1/3. You put a third of your money into each of those asset classes. That’s it.

This is far simpler than the portfolio optimization pioneered in 1952 by economist Harry Markowitz, who won the 1990 Nobel Prize for it. Today, Markowitz’s complex mathematical formulas underlie Modern Portfolio Theory, which fund managers and their ilk use to attempt to most effectively and efficiently balance risk and return.

Interestingly, for his personal portfolio Markowitz eschewed the complexity and used naïve diversification. In interviews (http://articles.chicagotribune.com/2010-01-31/news/1001290296_1_bond-funds-stocks-investing), he has revealed that he himself put half his savings in stocks and half in bonds. No struggles with portfolio optimization, Monte Carlo simulation or any arithmetic that couldn’t be done on the back of an envelope. Markowitz later said he wanted a portfolio that performed about as well as the overall market and didn’t want to risk doing a lot worse.

Portfolio theory’s premise is that different asset classes, such as stocks and bonds, tend to move in different directions. Relatively speaking, one tends to be up when the other is down. This allows an investor to, among other things, buffer the effects of a downturn by having funds invested in different, uncorrelated asset classes.

Nobel notwithstanding, the theory has showed a few holes, notably during market declines like the one in 2008, when all asset classes lost big and diversification provided little protection. The problem is that average asset class correlations can cover up major fluctuations, and nobody can predict when one of those outliers is going to hit.

“It relies on the idea that you have an accurate forecast of how every asset class is going to perform,” explains Marcy Keckler, vice president of financial advice strategy for Minneapolis-based Ameriprise (http://www.ameriprise.com). “And we don’t really know that.” Some studies (http://rfs.oxfordjournals.org/content/22/5/1915.abstract) suggest the estimation challenge is so significant that it would take centuries for an optimized portfolio to reliably beat naïve diversification.

Another objection is that recently asset classes that seemed uncorrelated have correlated more closely. “Over the last couple of years, whether you owned large caps, small caps, domestic or international, they’ve all been moving in unison,” says Michael Chadwick (http://www.fiscalwisdom.com), a financial advisor in Unionville, Conn. “Even stocks and bonds had been negatively correlated and now they’re correlated.”

So if naïve diversification performs about as well as fancier approaches, why not do it? One problem is that as assets gain or lose in value relative to each other, investors need to maintain the 1/N ratio.

“If one doesn't periodically rebalance, then one has an imbalance of securities as the outperforming stocks will have a larger weight than the stocks that have underperformed,” explains Robert R. Johnson, president and CEO of The American College of Financial Services (http://www.theamericancollege.edu/) in Bryn Mawr, Pa. “Moving forward, stocks that have underperformed in the past tend to outperform in the future. In other words, there is a reversion to the mean in stock returns."

Having said that, Johnson says 1/N diversification can be effective. And you can do it by investing in just a handful of stocks. "Somewhere in the range of 90% of diversification benefits are achieved with as few as 10 stocks," Johnson said. "You don't have to have dozens of individual holdings to diversify."

The easiest, most effective and efficient way for individual investors to do naïve diversification is through funds. Johnson says investors could look at index funds, which attempt to represent the composition and performance of a broad index like the S&P 500. Keckler says another option is target funds, which are managed to achieve diversification appropriate to a person retiring in some specific future year, such as 2025.

Chadwick, skeptical of diversification's ability to help investors prosper during periods of high volatility, favors a more sophisticated approach involving managed futures. These allow individual investors to hedge against risk with the help of professional money managers.

While financial advisors differ about whether naïve diversification is sufficient, as well as the details of how to go about it, they agree that attempting to manage risk by investing in different assets classes is centrally important. "We do know what when some asset classes are performing well, other asset classes might not be performing as well, and vice versa," says Keckler. "That's really the heart of a diversification strategy."