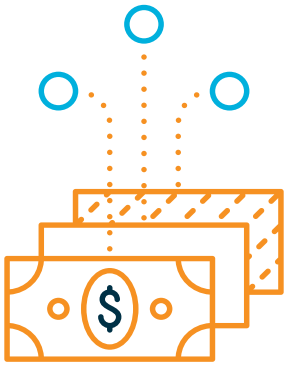
How Diversification Can Help Small Business Owners Manage Risk

Business Owners Should Consider Their Total Risk Factor

Most investors understand the notion of diversification. We hear all the time that spreading our portfolios' holdings across many asset classes is the best defense against losses when the bears hit Wall Street.

But as a business owner, there is a good chance that your diversification strategy may not work as you intended. Here's why.

Diversification 101



The cornerstone of diversification is a mixture of investments, each of which has broadly differing patterns of strength and weakness. That way, strengths in one investment can potentially offset weaknesses in another at any given time. The greater the difference in performance patterns of any two investments, the bigger the potential benefit from diversification.

Historically, alternative investments such as real property and precious metals provided a non-correlated counterbalance in portfolios to traditional holdings such as stocks.

Over the past decade, some investments that once differed significantly began performing more alike and this reduced their potential to offset each other's ups and downs in your portfolio. As financial instruments and global markets became increasingly liquid and accessible, different asset classes became more closely interrelated.

Correlation is Important

Correlation is a common measure of the variation in performance between two investments—the lower the correlation, the greater the potential to diversify your holdings. A correlation of zero denotes no statistically measurable relationship between changes in one set of returns and changes in another. In other words, the less alike two investments are, the less likely they are to both drop in the same market conditions.

But investors need to remember that different asset classes that once tended to correlate at a relatively low level, might have increased in correlation in recent years, so it's important to review diversification and correlations at least yearly.

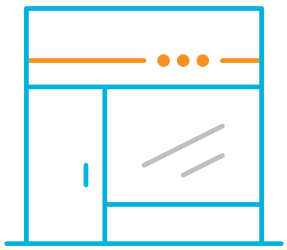
Be Careful of So-Called “Rules"

One of the most often-cited diversification “rules" from investors is the relationship between stocks and bonds. This “rule" states that when stock prices go up, bond prices go down, meaning stocks and bonds have an inverse relationship.

Logically, one can see how many might arrive at this “rule" because one might think that investors essentially chose between risky, high-return potential of stocks or the safe, relatively low-return potential of bonds. And since investors must sell one in order to buy the other, bond prices tend to drop when stocks are rising and vice versa, right? Well, as logical as that might actually sound, the exact opposite has occurred on many occasions—stocks and bonds have actually have risen and fallen in tandem.

The fact is that stock-bond correlations have not always been negative. In fact, over the long-term, stock-bond correlations average roughly zero. In recent times, however, there have been two fairly distinct periods—from the 1980s through the tech bubble, stocks and bonds were somewhat correlated, and since 2000, stocks and bonds have tended to move in opposite directions.

As a Business Owner



In very simple terms, many might consider an allocation of 60 percent equities and 40 percent fixed-income to be diversified. But such a setup, especially for business owners, is far too simplistic. The better approach is to:

- Review your entire risk profile (which includes your business)
- Not treat all equities as equally risky and all bonds as equally safe.
- Make finer distinctions within asset classes.

Failing to account for the risk profile of your business, which is a very common occurrence among business owners, can give you the appearance of being diversified, but you are really dominated by the same risk factor.

Factors to Consider

For a business owner, the idea of diversification is to keep risk at your manageable level, right? Well, as you consider your investments and create distinctions within larger asset classes, where would you categorize your business? Is your business:

- Dependent on seasonal spending?
- Dependent upon particular raw materials that fluctuate in availability and cost?
- Focused on a particular sector, like health care or technology?
- More likely to succeed when consumer spending increases?
- More likely to improve when general economic conditions deteriorate?

Many investors are trained to think of portfolio construction as a collection of assets, which concentrates portfolio risk into a single factor, such as equity risk. But investors, especially business owners, might take it a step further and consider portfolio construction by risk factor, not just asset class.

The Biggest Danger

As a business owner, one of the greatest dangers to diversification is, in fact, your business. Many owners would rather reinvest their earnings back into their business. While this approach might be appropriate at certain times, it is really no different than investing everything into U.S. Large Cap Growth stocks, for example. The end-result is that you will have “all your eggs in one basket," and your risk profile will increase dramatically.

While it's understandable that a business owner would much rather invest in their business rather than figure out an appropriate asset allocation plan, research the changing correlations among asset classes, and categorize her business into an asset class, this approach may jeopardize the owner's financial security.

This is where an experienced financial advisor can help you create a plan that secures your future. If you have questions about this or any other topic, please let me know.