The Optimistic Investor®

Focus on What Really Matters

Strength in Numbers: The Benefits of Broad Diversification

The early months of 2025 have been awash with headlines about the economy. Tariffs and government spending cuts have dominated the news, and the media is reveling in the opportunity to sound alarms about inflation, economic recession, and a stock market correction.

The media's portrayal of the world directly undermines the mindset that leads to successful investing. Good investors keep an optimistic long-term perspective, because they recognize that innovation and advancement are continuously improving our quality of life and corporate profits (and thus share prices) over time. Unfortunately, news coverage is relentlessly negative and myopically focused on current events.

Our last two editions addressed the importance of long-term perspective. In September, we looked at the fickle nature of market sentiment and how long-term plans help us stay focused on our goals when the rest of the world fixates on negative headlines. Then in December, we reviewed the fact that our willingness to endure uncertainty and occasional equity market declines is what drives the returns that keep our long-term plans on track.[1]

Having previously highlighted the need for positivity and a long-term focus, this quarter we'll discuss how we build equity portfolios that reinforce that mindset. The core principle is broad diversification, which plays both offensive and defensive roles in our portfolios. We'll explore each in turn to explain how diversification maximizes our likelihood of long-term success and best positions us to reap the benefits of the optimism we work so hard to maintain.[2]

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[1] *If you missed those essays, you can access them using these links: Navigating the Noise (September 2024); and The Only Certainty We Have Is Uncertainty (December 2024).*

[2] *Before diving into equity diversification, it's important to note that diversification amongst "asset classes" is also part of prudent investing. Investors should always keep adequate cash reserves, and in many instances should maintain a quality bond portfolio as well.*

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Diversification on Offense

The offensive role of broad diversification is that it helps generate the growth we need to be successful by making sure our long-term returns are in line with broad markets. This is important because most of us cannot earn and save enough money to account for every dollar we'll need to consume during our lifetimes. We need our savings to grow to stay on track for a comfortable retirement, financial independence, and the legacies we hope to leave.

Over time, stocks have generally done a much better job of outpacing inflation and increasing wealth than bonds and cash. We call that the equity premium and it's how we drive the growth we need. And when we're talking about thousands of publicly traded companies in the aggregate, we can be confident that an efficient market will deliver an equity premium in the long run.[3]

That's not necessarily true when we're talking about individual companies. For a variety of different reasons, an individual company's stock price can stagnate or decline for long periods of time; and companies can even go bankrupt, which generally means their shares become worthless.

The risks of investing in an individual company go far beyond whether the company is a "good" or "bad" business. Innovation and advancement benefit society and broad markets, but they can be highly disruptive for individual companies that don't or can't adapt as the world changes. History is replete with "great" companies whose share prices didn't keep pace with broader markets over time.

The best example we have of this is Cisco Systems. For those who aren't familiar, Cisco is a Fortune 500 company with a central role in the world of IT infrastructure. It produces hardware and software that are critical elements of the networks and data centers we all rely on every day. And it's played that role for decades.

In the dot-com era of the late 1990s, Cisco was widely viewed as a "can't miss" or "must own" stock. Its share price experienced an incredible rally and reached a peak of $80.06 on March 27, 2000. Since then, it has remained a leader in its field and played a key role in society realizing the potential of the internet. Yet, nearly 25 years later, on March 14, 2025, Cisco's stock closed at $60.50, meaning the share price has experienced a cumulative ***decline*** of 24.4% since its peak in March 2000. In contrast, the S&P 500 (which includes Cisco) closed at 1,523.86 on March 27, 2000, and 5,638.94 on March 14, 2025, for a cumulative ***return*** of 270.0% during that period.[4]

> "Broad diversification is how we give ourselves the best chance we can of achieving the growth we need to be successful over time."

The offensive aspect of diversification is how we avoid outcomes like this and proactively pursue the returns we need to achieve our goals. Some people like buying individual stocks because they think the stocks they pick will produce big returns. But successful investing isn't just about the returns a portfolio generates; it's also about the reliability of those returns over time. Picking individual stocks may offer the ***possibility*** of higher returns, but the company-specific risks you must bear to create that possibility don't guarantee better results. And the presence of those risks makes your long-term plan less reliable and more dependent on things that are completely outside your control. Broad diversification is how we avoid those unnecessary risks and give ourselves the best chance of achieving the growth we need to be successful over time.

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[3] *We discussed the equity premium in depth in our September 2023 edition, which you can access using this link: [The Importance of Earning the 'Equity Premium'](#)*

[4] *All price data obtained from finance.yahoo.com on March 15, 2025.*

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Diversification on Defense

While the offensive side of diversification is about earning returns, the defensive aspect is about remaining confident in times of equity market distress.

As we all know, the hardest time to maintain a long-term perspective is when markets are in turmoil. No one likes seeing account values go down, and the natural impulse is to ***do something*** to stop the decline. Of course, we also know that trying to time the markets is a fool's errand and that bailing out of our equity portfolios will hurt us in the long run. Broad diversification is our saving grace in these moments. It's the reason we can be confident that corrections and bear markets will ultimately be temporary, just as they always have before.

This concept is so important that we talk about it in almost every client meeting. On average, equity markets experience a "correction" (decline of 10%+) every year and a "bear market" (decline of 20%+) every 5-7 years. In our conversations with clients, we discuss how these rough patches have always presented a "timing risk" rather than a risk of permanent loss for those who could stay the course. The idea is that broad markets have ***always*** recovered from such declines and gone on to new highs when given enough time. And that means using cash reserves and quality bonds to cover needs while equity markets recover has allowed the "timing" risk to pass without incurring "losses."

Once again, we can be confident in this approach when we're talking about broad markets in the aggregate. Corrections and bear markets are generally caused by systemic issues that affect all companies in some way. We tend to experience a major shock that initially seems unsolvable, but in time a solution appears (often when it seems all hope is lost). And when that happens, markets stabilize and eventually a recovery begins to take hold.

It can be a very different story for individual companies. The systemic issues that cause broad market declines don't impact all companies and sectors equally, and sometimes firms struggle and fail under the weight of those issues. The declines are not temporary for the shareholders of such companies.

We saw this dynamic play out vividly during the 2008 financial crisis, in which many businesses and several iconic companies failed. Most notably, Lehman Brothers and General Motors declared bankruptcy and their shareholders suffered permanent and near-total losses. Meanwhile, the S&P 500 (which included Lehman Brothers and GM) reached its pre-crisis peak in October 2007, bottomed out in March 2009, and completed its recovery in March 2013.[5]

This example shows that the defensive aspect of broad diversification isn't just about "reducing" risk. It's also about controlling the type of risk we assume. When you try to pick individual stocks, you increase the risk in your portfolio; but you also ***change the nature of your risk*** from what we describe as a "timing" risk to a risk of permanent loss that can derail your long-term plans. Broad diversification prevents that conversion and allows us to remain confident that equity market corrections and bear markets will ultimately prove temporary.

> "Broad diversification allows us to remain confident that equity market corrections and bear markets will ultimately prove temporary."

As we close out this quarter's essay, we want to highlight that, although they address different elements of planning and investing, the offensive and defensive aspects of diversification also have a common theme. Namely, they both help us avoid unnecessary risks and maintain confidence in the long-term prospects of our equity portfolios. By understanding that and using a broadly diversified approach, we can reinforce our long-term optimism, strengthen the reliability of our plans, and maximize our chances of achieving our future goals.

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[5] *S&P 500 levels confirmed at finance.yahoo.com on March 15, 2025.*

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Innovation and Good News

1. Next month, the annual Chelsea Garden Show will feature an "intelligent" garden that uses sensors and artificial intelligence to monitor plant welfare. The system monitors things like soil moisture and light filtration that are otherwise difficult to observe, allowing gardeners to better care for plants. As the technology is adopted over time, it should increase crop yields and decrease the resources (like water) needed to produce them. A great example of how innovation can start small and then have a tremendous impact.

2. Last quarter we highlighted Google's development of a new chip (Willow) that represented major steps forward for quantum computing. Not to be outdone, Microsoft (Majorana 1) and Amazon (Ocelot) announced their own quantum chips just a couple of months later. Competition is a big driver of innovation, so it's exciting to see multiple advances in this area.

3. In more Google news, Google's self-driving car unit (called Waymo) is now providing over 200,000 driverless tax rides per week. And recent analysis by a major insurance company (Swiss Re) concluded that these vehicles are more than 10-times safer than human drivers.

4. Researchers at Northwestern University recently published a paper suggesting it might be possible to harness the human brain's own immune cells (called microglia) to combat Alzheimer's disease.

5. Also in the fight against Alzheimer's, last month researchers at the University of Pittsburgh announced a new test that can identify clumping tau protein up to 10 years before the clumps become visible on brain scans. Clumps of tau protein are believed to be a cause of the disease, so earlier detection may allow for effective treatment before the condition gets worse.

6. A clinical trial has shown that a new type of bone marrow transplant can cure sickle cell anemia at roughly 25% of the cost of recently-approved gene therapies.

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