Diversification with Index Funds

If I own three funds, am I diversified?

ALEX
Sam, would you like potato salad, potato salad with dill, or … mine?

SAM
You asked three neighbors to bring a side. Did anybody say which one?



ALEX
Next time I'll ask before I boil the potatoes. Hang on. Did I just do this with my funds?

SAM
Bring your two fact sheets over. Let's see what showed up twice.



The neighborhood potluck

At the neighborhood potluck, Alex lifts three lids in a row. Potato salad. Potato salad with dill. Her own potato salad, with mustard. Sam hands her a fork. "At least we know what everybody likes."

Find the company that shows up twice

Diversification with Index Funds

ALEX
There's Harbor Systems in my broad U.S. fund. Eight percent. And there it is in the growth fund at twenty!

SAM
Suppose you put $50 in each. How much Harbor did your first $50 buy?



ALEX
Four dollars. And the second fifty bought ten. So fourteen of my hundred dollars depend on one company.

SAM
Exactly. With the broad fund alone it would have been eight. Adding a fund made that particular bet bigger.



Two different funds, one shared holding

Broad U.S. fund · $50 × 8%	**$4 in Harbor**
U.S. growth fund · $50 × 20%	**$10 in Harbor**
Across her $100 investment	**$14 in Harbor**

What would a third fund add?

Diversification with Index Funds

ALEX
This international fund holds the Japanese company that makes our bakery mixer. That's a new name.

SAM
It adds businesses in other countries. If stocks fall around the world, what might happen to all three funds?



ALEX
They could all fall. Your Treasury bill would do a different job, wouldn't it?

SAM
Yes. Held to maturity, it promises a stated dollar payment on a known date. Think about when you'll need the money.



What changes when Alex adds it?

Company mix	**New holdings**
Geography	**More countries**
Investment type	**Still stocks**

Give each holding a job

Diversification with Index Funds

ALEX
What if I put $75 in the broad fund and only $25 in the growth fund?

SAM
Same Harbor weights. Try eight percent of $75, then twenty percent of $25.



ALEX
Six dollars plus five. Eleven in Harbor this time. Now I can decide how much I want there.

SAM
That’s a question a fund count can’t answer. Look for repeated holdings, their weights, and risks the funds share.



Alex’s three questions

What businesses repeat?	**Compare holdings**
Where are my biggest bets?	**Check weights**
What could fall together?	**Compare risks**

Try it: split $100 equally across the two U.S. funds and the international fund. If the international fund holds no Harbor, about $9.33 of your $100 is in Harbor.

Sources Diversification Index funds