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Article: Redefining long-term diversification

The market slump forces financial advisers to rethink retirement allocations
By Chat Reynders
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With risk tolerance and potential returns plummeting as the entire U.S. financial infrastructure remains in flux, financial advisers and investors are taking a new look at investing for retirement.

That process requires redefining "diversification."

Diversification isn't what it used to be. As commonly practiced, it falls well short of the mark and actually overexposes investors to weak areas of the market.

In fact, it played no small part in the crisis; in the name of diversification, a great many assets were pumped into financial stocks, unstable emerging markets and commodities that had a short-lived upward trajectory.

This mainstream approach to long-term diversification amounts to an investment punt — a claim to cover all bases **without assuming any specific responsibility.** The result has been a domino effect of crashing investments, with each area of diversification collapsing on top of the next.

To protect against market downside, retirement-oriented **investors must employ "intelligent diversification."** That means using managers who are proactive in investigating the fundamental strength of each investment by first identifying discrete sectors and then overlaying an understanding of sector stability, equity valuation and growth potential.

This demands active responsibility for maintaining portfolios — not just amid market shifts but amid market opportunities.

Using intelligent diversification could have eased some of the damage inflicted by the market. For advisers, this means looking for long-term opportunities with strong, ethically managed companies that are out of the market's favor and therefore are undervalued.

Just as important, advisers must have the discipline to avoid investments where risk can't be measured well. Here are three signs to look for:

• A low debt/asset ratio. Long a sign of a strong balance sheet, a low debt/ asset ratio frees management to pursue initiatives it thinks will benefit stakeholders.

• Consistent increases in dividend yields. When management gives cash back to its investors, it demonstrates a key ethical value: that company leadership is committed to the long haul and wants investors to remain as committed as it is.

• Disruption opportunities. Intelligent diversification calls for an awareness of undervalued areas that are poised for a big change — and individual companies that are built to capitalize on such opportunities.

Advisers looking for investments intended to carry investors through many years of retirement should note that several areas are on the brink of disruption and show great promise over the coming years. The auto industry, for one, is feeling considerable pain, and there is rampant speculation that one or more of the major automakers may not survive.

Yet under the surface, much is going on. Hybrid sales are on the rise, and new technology is being developed that is likely to reshape the business. Unexpected players are ready to enter the auto game, including energy companies that are learning to adapt their technology to the mass market.

Specifically, this could spell a lucrative opportunity for carbon fiber companies, which will contribute to the development of fuel efficiency. Hybrid-auto manufacturers also bear watching, as do energy infrastructure players that can develop compatible technology for plug-in hybrids.

Another area to watch is health care. It is an issue on everyone's mind as costs skyrocket and millions of baby boomers approach their senior years. Companies that focus on providing affordable solutions for managed care and preventive drugs will make an impact on the industry.

Disruption brought about by climate change also will create imperatives for efficient infrastructure and developing new forms of energy. Innovative companies that produce alternative energy, improved energy efficiency and changes in transmission and delivery are already moving to the front of the investment conversation.

Approaching diversification involves following a proactive strategy of building portfolios that seek low-risk opportunities in a range of sectors.

As Warren E. Buffett famously quipped, ***"Diversification is protection against ignorance."*** Diversifying the right way can help clients weather market volatility and thrive over a long retirement.

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