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What real diversification looks like beyond a core portfolio

JAMIE STURGEON
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Effectively building around a core investment portfolio can be complex. Adding investments does not automatically boost diversification, and the fortunes of those investments can remain tied to much the same macro conditions.

Robert Wilson, head of innovation and portfolio strategist at Picton Investments, provides an example to explain the challenge. A ski shop can expand its offerings by stocking snowboards, but by summer, both options will sit unsold. Adding mountain bikes would give customers a reason to return and spend money when the snow is gone. “Should you add snowboards to your shelf, or should you add mountain bikes? What would make more sense?”

Broad-market exchange-traded funds or balanced mutual funds provide what many investors need for an accessible, low-maintenance foundation. From there, they can choose among specialized vehicles that pursue additional growth, income or downside protection. Before expanding, however, investors need to understand what gaps in the portfolio those new positions are filling.

“The burden of proof always sits with the satellite and not the core. It has to add something,” says Abie Quayson, a portfolio manager at Harbourfront Wealth Management in Toronto.

For Mr. Wilson, a central concern is how a portfolio responds when inflation disrupts markets. Stocks and government bonds can complement each other when economic growth disappoints. While weaker earnings weigh on equities, expectations of lower interest rates can lift bond prices. An inflation surprise pushes both down, as investors infamously experienced in 2022.

That recent history helps inform Mr. Wilson's preferred allocation: 40 per cent equities, 30 per cent bonds and 30 per cent in a combination of alternative investments he deems as either "return enhancers" or "diversifiers."

The final portion brings together investments with different purposes. Private equity, for example, can expand access to businesses beyond public markets and give skilled managers greater influence over return dynamics. That's an enhancer. Still, Mr. Wilson cautions that private equity isn't magically disconnected from the same economic forces that shape public equities.

For broader diversification, he points to commodities and strategies designed to reduce dependence on market direction. Market-neutral funds, for instance, combine positions expected to appreciate with short positions that can benefit from falling prices.

Karen Routledge, a portfolio manager at Wagner Investment Management Team in Calgary, part of Wellington-Altus Private Wealth, generally suggests keeping satellite positions at about 10 per cent to 20 per cent, depending on risk tolerance.

Ms. Quayson also takes a conservative approach, saying that sizing positions should be small enough that a severe setback wouldn't disrupt the overall plan.

The first step in building around the core is examining what's already owned. A technology fund layered onto an S&P 500 holding, for example, may increase ownership of companies already prominent in the portfolio. "You have to look under the hood of your core," Ms. Routledge says.

Even different companies can share a vulnerability. Mr. Wilson describes a portfolio holding a technology business, a data-centre builder and a uranium producer. Across three different sectors, the economics driving AI investment underpin each.

Ms. Quayson encourages investors to consider what would allow a proposed holding to outperform. An active small-company fund could introduce businesses underrepresented in a large-company core, although it would retain equity-market risk.

For thematic, narrative-driven investments, the price paid deserves particular scrutiny. "Paying the full price for a story that everyone knows is how even a real or durable theme could be a poor investment," Ms. Quayson says.

Fees raise the hurdle. Many thematic strategies or funds are actively managed, and Ms. Routledge says investors should assess whether that manager's contribution justifies the additional expense.

Income-oriented satellites require similar scrutiny. A generous distribution can attract attention while revealing little about the investment's underlying sustainability. "You should not focus on the amount of the distribution," Mr. Wilson says.

Persistent erosion of the investment's unit or share price suggests it's paying out holders at an unsustainable level.

To understand a satellite position's contribution to the core, Ms. Quayson recommends writing down the investment rationale and the conditions that would prompt a sale, then establishing review dates and rebalancing limits. "The core should still set the portfolio's character."

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