You've heard of diversification: Spreading your investments around to avoid being over-exposed to any one type of asset. Done properly, diversification can help reduce the volatility of your portfolio over time while keeping you on track to meet your growth goals.

Then there's what we call di-worse-ification, a situation where an investment portfolio has so many stocks that the result is unnecessary risk without the benefit of higher returns. In fact, over-diversification can be a drag on returns. Imagine you bought Apple 30 years ago, when shares were still cheap, and held it; you'd have a massive return right now. On the other hand, if you invested in an index fund whose holdings included Apple, you'd likely have a far smaller return.

That's an over-simplified example, but you get the point. The more stocks you own, the more likely your returns will mirror the larger market's returns. Owning a limited number of high-conviction stocks, on the other hand, gives you a chance to beat the market. Of course that approach is not as safe as buying the market—there's no guarantee that high conviction portfolios won't underperform.

Over the past few years, there was less downside to owning funds with hundreds of holdings: Thanks to the federal government's fiscal and monetary policies, the broad market rose, and many index funds did well. However, the Federal Reserve is now pivoting to an inflation-fighting stance. It's expected to raise interest rates and wind down the bond purchases that have been propping up the economy and the markets.

As a consequence, we're moving into an environment in which it will be more important to distinguish between promising stocks and those that seem likely to stagnate or decline in the next few years. An over-diversified portfolio is more likely to include clunkers that will increase risk and dampen returns. Yes, broad portfolios will be more likely to match the overall market's rate of return, but as the first several weeks of 2022 have demonstrated, the jacked-up returns of the past few years have likely come to an end.

If you own shares of a big mutual fund, understand that the fund may not be nimble enough to quickly get rid of worrisome holdings. Many funds loaded up on work-from-home stocks while that category boomed, for instance. Those stocks have been crashing as Covid-19 concerns begin to wane. But large funds are wary of selling big blocks of stocks because, as they add

supply to the market, they drive down the price of the stock before it's all been sold.

On a related note, many funds require each of their holdings to make up at least half a percent of their total holdings. That can make it hard for them to buy promising small-cap stocks, which typically have the most runway to grow.

The bottom line: Now is a good time to take a fresh look at your investment portfolio, to ensure you're confident in the sectors and individual stocks you own, to add names where you need to, and to potentially cut loose those you're not as confident in. Over the next few years, I expect that the market will continue to be volatile, but will reward investors who have constructed focused, forward-looking portfolios. Please don't hesitate to contact us if you'd like to discuss your investments.