

February 2026

*Note: Last year, we introduced the first in what we envision as a series of short articles addressing the question: "What is Value Investing?" Here, we debut the first short article to tackle the related question: "What is Risk?" Brandes Center Advisory Board member Barry Gillman, CFA summarized Chapter 6 of Joe Wiggins' book, *The Intelligent Fund Investor\**, published by Harriman House in 2022. Look for similar articles in the future.*

*ChatGPT offered this summary of Wiggins' book: "The Intelligent Fund Investor is a practical investment book aimed at helping both individual and professional investors make smarter decisions when selecting and managing investment funds—including both active funds and passive vehicles like ETFs. Wiggins combines behavioral finance insights with evidence-based analysis to expose common pitfalls and offer clear, actionable advice for better long-term outcomes."*

## **DIVERSIFICATION IS NOT EASY: A BEHAVIORAL PERSPECTIVE**

### *WHEN IT'S RIGHT TO WANT TO BE WRONG*

Diversification is often called 'the only free lunch' in investing. The concept is based on the generally sound principle that by investing in a range of securities, funds and asset classes with different characteristics, we can reduce the risks that we face without impairing our return prospects (we might even improve them).

Diversification is both simpler and more important than this description suggests. While diversification is now typically discussed in terms of correlations and volatilities, it is really about confidence. Diversifying our investments is an acceptance that we cannot predict the future and that we will be wrong about many things. The more confident we are, the more concentrated our investments can be. With perfect foresight we would only invest in one security.

If we want to understand an investor's confidence, we need to check their diversification.

**Diversification is behaviorally challenging for investors for two reasons:**

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**1. We are forced into making decisions that we think will be wrong.**

**2. We will always be holding onto investments that are performing relatively poorly.**

Let's explain why.

Assume we own two portfolios investing in global equities. One is invested in large businesses, with rapidly growing earnings, the other in small value stocks. Given the distinct nature of these investments, they should provide some diversification benefits. A period in the sun for cheap and small companies will likely mean struggles for their larger, rapidly growing counterparts.

When our small-cap value fund is outperforming, how do we feel?

Probably frustrated. Frustrated at the disappointing performance of the large company fund we hold. Questioning why we didn't and don't own more of the small company fund. Because it is underperforming, it will be easy to find problems with the large strategy and simple to justify removing or reducing it.

To be appropriately diversified it is not enough for us to be happy to hold things that feel like they are not performing; **we must want them not to work.**

If all the holdings in our portfolio are going up at the same rate at the same time, we have a problem. It just won't feel like a problem until it's too late.

Good investing is often framed as the avoidance of mistakes. While this is true in some regards, prudent diversification means being comfortable making decisions that we think will look like mistakes. When investing in those large and small company funds, we will inevitably have a preference between the two. We will likely hold an expectation about one being able to produce higher returns than the other.

Despite this we should invest in both —because we are fallible, and the future is unknowable. Appropriate diversification means always holding some assets that appear to be stragglers. This is the intended result. We can think of such positions as failures or costs. Alternatively, we can consider them to be holdings that would have fared better in a different scenario to the one which transpired.

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Diversifying our risks appropriately is challenging because it forces us to make decisions not only that we think are likely to be wrong and costly, but that **we want to be wrong and costly**. This is difficult to justify to ourselves, let alone others.

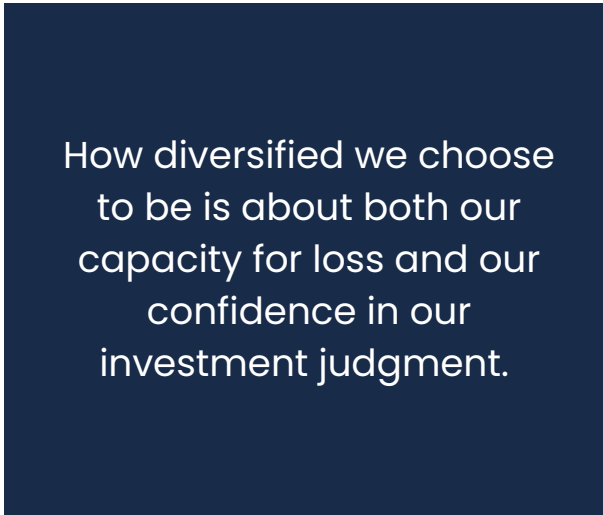
For example, many investors hold a majority of their equities in domestic stocks, and diversify by holding a modest amount internationally. If domestic stocks then outperform, they are more likely to curse their conservatism than think about the other possible outcomes that could have transpired. “We were right, so why didn't we back ourselves more?”

After the event, diversification only feels gratifying if we were wrong. If we were right, it feels like a cost. If we bet on a racehorse to “win, place and show” and it wins, we will rue the fact that we didn't bet solely on a victory. Our struggle to diversify appropriately is related to loss aversion: our tendency to experience the pain of losses more acutely than the pleasure of commensurate gains.

This behavioral trait fosters a propensity to view diversification through a negative lens, focusing on the investments that failed to perform, rather than those that did well.

When we make an investment decision, there are a huge range of potential, unknowable paths. After the event, only one route has been taken and a binary judgement will be made—were we right or wrong? To make matters worse, everyone tends to feel that the result was obvious at the time we made our decision.

Such criticism tends to be magnified when there is a “disaster” in our portfolio. The risk of disaster is always an issue of diversification. Even if we make an investment that goes bankrupt, if it is only 3% of our overall portfolio, the consequences are likely to be bearable. How diversified we choose to be is about both our capacity for loss and our confidence in our investment judgment.



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Thinking about the risk of disaster is problematic because it doesn't fit into the traditional risk and return framework within which the asset management industry operates. Indeed, the concept that more risk should result in greater returns is flawed and dangerous when assessing the threat of large and disastrous losses.

There is no "right" level of diversification. It is dependent on the requirements and characteristics of each investor. Diversification is no panacea. However, investors should assume that the more concentrated and confident we are, the greater the risk of disaster.

Here are four questions investors might use as a self-assessment checklist:


**1. Could we survive a blowup?** If one stock or area of the market went badly wrong, could our portfolio survive?

**2. What don't we own?** Concentration risk is as much about what we don't own as what we do. The more concentrated we are, the more vulnerable we are to strong performance from areas of the market we do not hold.

**3. Are we really diversified?** It's easy to appear diversified by owning multiple investments, but if all of these are invested in similar areas or are exposed to consistent themes, we still carry considerable concentration risk.

**4. Is our level of diversification consistent with our confidence?** Diversification is about confidence. The more concentrated and undiversified we are, the more confident about our investment views we must be.

**Diversification is much harder than it looks.**



Investors should assume that the more concentrated and confident we are, the greater the risk of disaster.

\*Wiggins, Joe.  
*The Intelligent Fund Investor.*  
*Practical Steps for Better Results in Active and Passive Funds.*  
 Petersfield, UK: Harriman House, 2022

## DISCLOSURES

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

**Past performance is not a guarantee of future results.**

**No investment strategy can assure a profit or protect against loss.**

**Diversification does not assure a profit or protect against a loss in a declining market.**

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful. It should not be assumed that any security transactions, holdings or sector discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. Stocks of small companies usually experience more volatility than mid and large sized companies. Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk.

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