Why mutual fund investors should be worried about over-diversification

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Many new mutual fund investors are getting to know the perils of over-diversification these days. These investors, who have amassed many top-performing schemes in their quest to diversify their mutual fund portfolio, have been told by various mutual fund experts that their portfolio is full of similar schemes that will only dilute the overall returns. Here are some pointers that would help you to avoid the mistake in future.

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"Diversification protects you from risk, but over-diversification may lead to lower returns. Diversifying across categories gives you an edge when a category is underperforming. However, having many schemes in the same category with similar stocks might hurt your capital when the category is going through a bad phase," says Neeraj Chauhan, CEO, The Financial Mall. "Over-diversification is bad not only because you end up investing in similar schemes in the same category which minimises your returns, but it also makes you portfolio unmanageable. It is always good to choose only one scheme from one category," he adds.

How does one get around the problem? Can relying on an expert help to avoid this trap? Well, an expert is not a guarantee against over-diversification. We have seen many investors with a large number of schemes in their portfolio. Surprisingly, they were recommended by mutual fund advisors. However, it is true that DIY (or Do It Yourself) investors are more prone to overdiversification.

This is mainly because DIY-investors usually pick schemes from various sources and experts, say mutual fund advisors. Even if they pick two or three experts and their recommendations, they would end up with a large number of schemes in their portfolio. Another trouble is that experts are muted when it comes sell recommendations. Often investors end up with a lot of dud schemes in their portfolios.

A way out is to focus on consistent performers rather than chart busters or dark horses. "The purpose of recommendations is to let you know about the consistent schemes. You have to invest in the schemes as per your need. Different portals might recommend different schemes but you have to choose the scheme that suits your financial goals the best," says Vishal Dhawan, a certified financial planner.

"If you want to invest only as per the recommended list, see which scheme is common in all the recommendations. Moreover, you goal should be to beat the benchmark consistently. There will always be another scheme which might perform better than your scheme, that doesn't make your scheme is any less," says Neeraj Chauhan.

Similarly, do not be trigger happy and chase returns. Always give enough time for your schemes to perform. Stopping investments in one scheme and starting in another, shifting to a top-performer from an underperformer .., if you do these stunts regualry, there are chances that you may end up with a bloated mutual fund portfolio.

Choose a scheme that matches your goal and investment philosophy. Make sure that you have faith in the fund manager, and have the conviction to stick with him for a long haul.

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