The Importance Of Diversification

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Diversification is a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. It aims to maximize return by investing in different areas that would each react differently to the same event. Most investment professionals agree that, although it does not guarantee against loss, diversification is the most important component of reaching long-range financial goals while minimizing risk. Here we look at why this is true, and how to accomplish diversification in your portfolio.

Different Types of Risk
Investors confront two main types of risk when investing:

- ***Undiversifiable*** - Also known as "systematic" or "market risk", undiversifiable risk is associated with every company. Causes are things like inflation rates, exchange rates, political instability, war and interest rates. This type of risk is not specific to a particular company and/or industry, and it cannot be eliminated or reduced through diversification; it is just a risk that investors must accept.
- ***Diversifiable*** - This risk is also known as "unsystematic risk", and it is specific to a company, industry, market, economy or country; it can be reduced through diversification. The most common sources of unsystematic risk are business risk and financial risk. Thus, the aim is to invest in various assets so that they will not all be affected the same way by market events.

Why You Should Diversify
Let's say you have a portfolio of only airline stocks. If it is publicly announced that airline pilots are going on an indefinite strike and that all flights are canceled, share prices of airline stocks will drop. Your portfolio will experience a noticeable drop in value. If, however, you counterbalanced the airline industry stocks with a couple of railway stocks, only part of your portfolio would be affected. In fact, there is a good chance that the railway stocks' prices would climb as passengers turn to trains as an alternative form of transportation.

But you could diversify even further because there are many risks that affect *both* rail and air because each is involved in transportation. An event that reduces any form of travel hurts both types of companies - statisticians would say that rail and air stocks have a strong correlation. Therefore, to achieve superior diversification, you would want to diversify across not only different types of

companies but also different types of industries. The more uncorrelated your stocks are, the better.

It's also important that you diversify among different asset classes. Because different assets - such as bonds and stocks - will not react in the same way to adverse events, a combination of asset classes will reduce your portfolio's sensitivity to market swings. Generally, the bond and equity markets move in opposite directions, so, if your portfolio is diversified across both areas, unpleasant movements in one will be offset by positive results in another.

There are additional types of diversification and many synthetic investment products have been created to accommodate investors' risk tolerance levels; however, these products can be very complicated and are not meant to be created by beginner or small investors. For those who have less investment experience and do not have the financial backing to enter into hedging activities, bonds are the most popular way to diversify against the stock market.

Unfortunately, even the best analysis of a company and its financial statements cannot guarantee that it won't be a losing investment. Diversification won't prevent a loss, but it can reduce the impact of fraud and bad information on your portfolio.

How Many Stocks You Should Have

Obviously owning five stocks is better than owning one, but there comes a point when adding more stocks to your portfolio ceases to make a difference. There is a debate over how many stocks are needed to reduce risk while maintaining a high return. The most conventional view argues that an investor can achieve optimal diversification with only 15 to 20 stocks spread across various industries. (To learn more about what constitutes a properly diversified stock portfolio, see *Over-Diversification Yields Diminishing Returns*. To learn about how to determine what kind of asset mix is appropriate for your risk tolerance, see *Achieving Optimal Asset Allocation*.)

Summary

Diversification can help an investor manage risk and reduce the volatility of an asset's price movements. Remember though, that no matter how diversified your portfolio is, risk can never be eliminated completely. You can reduce risk associated with individual stocks, but general market risks affect nearly every stock, so it is important to diversify also among different asset classes. The key is to find a medium between risk and return; this ensures that you achieve your financial goals while still getting a good night's rest.

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