Diversification

Investing for your retirement



Managing risk with common sense

An investor's approach to investing for the future can be similar to the approach used for other life decisions: Use common sense, and, as the saying goes, "Don't put all your eggs in one basket". This sums up the concept of diversification.

The fine print has a point

The fine print on investment-related materials often states that all investing involves some degree of risk. Diversification is one way to manage those risks. It's a concept that involves spreading an investor's dollars among a variety of investments.

By taking such an approach, an investor could be less affected by losses in any one investment; while any losses that are incurred may be offset by gains in another investment. Of course, as the fine print says, this approach doesn't guarantee better performance or protect against loss in declining markets.

Understanding performance

An investment portfolio often consists of any of three main asset classes: stocks, bonds and money market instruments (cash). Diversifying a portfolio involves identifying investments in segments of each asset category that may perform differently under different market conditions.

A "rain or shine" example

Let's say hypothetically that an individual invests in the stock of two companies – one manufactures raincoats, the other makes sunglasses. A rainy month brings great profits for the raincoat company, but profits slide during sunny months. So, the investor could help manage those highs and lows by investing in something that reacts differently to the same condition, the weather: sunglasses.

As this simplified example shows, a diversified portfolio can be made up entirely of investments in one asset class; in this case, that asset class is stocks.

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Diversifying through asset allocation

Historically, market conditions that cause one asset category to do well often cause another category to have average or poor returns. Consider the following scenario:

Win some, lose some

An investor has a portfolio that is equally invested in bonds and money market instruments. As interest rates rise, the value of the bonds in the portfolio drops accordingly, and the portfolio "loses" money. The investor's loss, however, is offset by an increase in value on the money market investments, as these two types of investments react differently to the same external forces – the change in interest rates.

This example is based on the principle of "asset allocation," which takes diversification a step further by spreading investments among and within different asset categories. Many investors use asset allocation to diversify their investments; however, a diversified portfolio doesn't necessarily need to be divided among different asset classes (as described in the "rain or shine" example).

Spreading your eggs among different baskets

No one expects individual investors to predict fluctuating interest rates or study the operations of each company and predict stock prices. Some investors seek full-time professional management – by investing in mutual funds.

Diversification and asset allocation can be helpful, although they can't assure or guarantee better performance, and can't protect against loss in declining markets. However, they are well-recognized risk management concepts. Other factors an investor can consider include taking into account their personal financial situation, investment objectives, tolerance for risk, and how long the investor has before the money is needed.



Talk to your financial professional about ways you can diversify your investments for retirement.

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