

Portfolio Diversification – Why, How Much and When

Many have heard the adage “Don’t put all your eggs in one basket.” This is good advice, but for many, hard to adhere to.



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times wrong when looking at specific situations. According to Investorwords.com, diversification is “A portfolio strategy designed to reduce exposure to risk by combining a variety of investments, such as stocks, bonds, and real estate, which are unlikely to all move in the same direction.” The goal is to reduce the risk contained in a portfolio by reducing the ‘volatility’, or change, within the portfolio.

Unfortunately, while diversification reduces the possibility of loss within a portfolio, it also reduces the potential

one would offset the losses of the other, leaving you with no net loss, but also with no net gain. Is that why you have investments?

Instead, consider diversification a strategy by which you can own a broad spectrum of the market to reduce ‘business risk’, the risk that any one business or class of businesses will perform poorly and diminish in value. It is true that with this type of diversification, your investments will nearly all move up or down in unison, (market risk),



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Most investment advisors will tell you that one of the best safety measures for your portfolio lies in ‘diversification.’ Before you plunge into rampant diversification, however, take a few minutes to understand what diversification is, what it can accomplish, and whether or not it is the best choice for you.

First, remember that any advice that is offered in broad strokes is many

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gain. Think of it this way: if you were to buy equal amounts of stock in two different companies, one of which would grow in a strong economy (for example, a lending company), and one which would grow in a weak, or recessive economy (such as a re-possession business), the gains of

but with some forethought and a little study, you can use this to your advantage.

I believe one of the best ways to look at how well diversified you are, is to take a good look at your entire net worth and holdings. I have run into many people that have several different mutual funds and feel they are diversified, but when you take the portfolio apart, it is not. As an example if your net worth is \$1,000,000 and you own \$700,000 in real estate and \$300,000 in stocks, bonds and cash, no matter how well you diversify your stock and bonds, your overall portfolio is not well diversified. Hence if real estate prices plunge by over 50%, this

portfolio will suffer over \$350,000.00 in lost equity. A better approach is to keep in mind the entire portfolio and not let one asset class become too large.

A Registered Investment Advisor (RIA) spends many hours per week analyzing, not only the present market conditions, but months and sometimes years into the future. He or she analyzes the economy as a whole at a macro level, as well as watches for significant business events on the horizon. No one can predict the future, but with knowledge and experience, it can be possible to anticipate trends. Armed with this information, an RIA can recommend moves in portions of your portfolio between asset classes and money market, depending on your allocation and risk tolerance.

This strategy takes advantage of diversification to reduce risk and can be the ideal way to maximize returns while minimizing risk. ■

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