Diminishing Investment Risk

Risk is not something you should try to eliminate from your portfolio. However, you must manage your risk. By choosing only ultra conservative investments, you limit the potential return on your investments. Instead, minimize your risk by diversifying your portfolio and choosing investments that will bring you peace of mind as well as your desired rate of return.

You can manage your investment risk through proper diversification, also known as asset allocation. In our world of uncertainty, it makes sense to reduce your risks wherever possible. This is especially true when it comes to investing. That's what diversification does. It's a way to reduce exposure to risk without reducing your potential for return.

Diversification is the spreading of your money into a variety of investments. Changes in economic conditions affect some securities differently, but the impact of any single asset category is minimized.

"Spread your risk through diversification."

Through diversification, you distribute your assets among a variety of investment categories and, thus, spread your risk. Of course, your personal situation and investment goals will affect the way in which you diversify your portfolio. You need to discern your objectives based on your age, family obligations, income needs, liquidity requirements, tax considerations, and tolerance for risk.

When you're determining your asset mix, consider these four types of diversification: across asset classes, across time horizons, across industries, and among companies.

Diversification Across Types of Securities

Investing among different categories of securities such as stocks, bonds, mutual funds, U.S. Treasuries, or money market instruments allows you to reduce your portfolio's exposure to any single part of the market. This type of diversification is also known as asset allocation. The key to asset allocation is understanding how different categories of assets react to various market changes in relation to one another.

One such correlation is that, during an economic downturn, most stocks tend to perform poorly. However, a slow economy can have just the opposite effect on the bond market. Because a sluggish economic environment is usually accompanied by lower interest rates, bonds will typically rise in value during an economic downturn. Therefore, by holding some stocks and some bonds, you can lessen the effects of economic volatility on your overall portfolio.

Diversification Across Time Horizons

While investing among different asset classes is important, proper diversification requires tailoring your portfolio to your needs. Investing across varying investment time horizons is the way to build a portfolio that is suited to your objectives, without sacrificing diversification.

For example, certificates of deposit, money market funds, and Treasury bills have relatively short time horizons. Other investments, like growth stocks, have long time horizons.

Investments with short time horizons can give your portfolio an anchor of stability. However, <u>if your portfolio is too heavily weighted in these asset classes, you take the risk of reduced return because of declining interest rates or increased inflation.</u>

On the other hand, investments with longer time horizons can result in significant capital appreciation in your portfolio. Stocks, for example, have historically been the best performing asset class over the long term. However, stocks require a long-term orientation in order to smooth out market volatility, the ups and downs of the market. Historically, the stock market has had up to four consecutive years of a declining market. This can devastate any portfolio immediately. If your need for money occurs during that time, not only will you lose on your investment, you may even incur substantial losses. Being too heavily weighted in investments with a long time horizon can deprive your portfolio of stability, as well as safety for emergency cash reserves over the short term. The best approach is to hold some long-term and some short-term investments to reduce overall fluctuation in your portfolio.

Diversification Across Industries

You can further diversify your portfolio by investing in companies in a variety of different industries. This reduces industry risk, the risk that an entire grouping of business will under-perform the market.

By dividing your portfolio among several industries, you ensure that its performance won't depend entirely on one type of business. Volatility in one industry will have only a negligible effect on your portfolio because you've spread your risk.

Diversification Among Different Companies

Within industries, it can make sense to diversify among stocks of different companies. This reduces what professionals call credit risk. This is the risk that any one company will experience difficulties because of factors such as poor management, a lack of market for their products or services, or the superiority of competition. It also reduces your risk should fraud and mismanagement be perpetrated by company management.