Investing Basics: Diversification

There is an old cliché that says “Don’t put all your eggs in one basket”. This statement is really about the importance of diversification. You may have heard that it is important for investors to diversify, but what does this mean, why is it important, and how is it achieved?

There are several cornerstones of investing and one of the most important is to diversify. Through diversification you are reducing your portfolio’s overall risk by spreading your monies across several different asset types. Diversification can be achieved by spreading out asset types (stock, bonds, CDs, cash, commodities, real estate, etc.) among different geographies, industries and maturities.

Diversification reduces overall portfolio risk by combining several asset types, each which carries its own unique set of risks and opportunities. All investments carry a certain type and level of risk. Even certificate of deposits (CDs) offer risk as the return may not keep up with the pace of inflation. This is referred to as purchasing power, or inflationary risk. Investments in stocks, real estate and mutual funds include risks associated with fluctuation or even loss of principal.

Unless you have a no-fail crystal ball and know what the future brings, it is important to diversify. No one single investment type is the best performing across all types of market and economic environments. If one of your investments falls in value but you have monies spread across other investments and asset classes, your overall portfolio doesn’t entirely “blow-up”.

Risk is present in all investments and those risks may prove evident in different market, economic and interest rate environments. However, the risk characteristics of each investment may differ. By diversifying your assets, you spreading your risk thus lowering the overall risk of the portfolio as a whole.

One of a Financial Advisor’s most important jobs is to help a client diversify their portfolio based on that client’s unique risk tolerance and time horizon profile. While diversification does not guarantee a positive return, it does reduce risk. “Money is like manure. You have to spread it around or it smells.” – J. Paul Getty.

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