Managing Risk through Diversification

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- One of the simplest methods of reducing risk in a fully invested portfolio is through diversification.
- A diversified portfolio benefits from holding assets that respond differently to market influences--the returns of holdings are not perfectly correlated.

With the stock market's wild gyrations in recent weeks, you may be wondering how you can reduce the risk in your portfolio. If you react emotionally to market volatility, odds are you will violate the market adage of "buy low, sell high."

Diversification

Structuring your portfolio to be diversified helps to manage its risk. Diversification is the combination of assets that respond differently to changes in the investment environment. For example, oil and airline stocks normally react in opposite directions to significant movements in the price of oil—an increase improves the revenue outlook of oil companies, yet raises the operating costs of airline companies. As a result, a rise in the price of oil can help oil stocks, but hurt airline stocks.

Correlation

As the correlation of returns among assets declines, such as with oil and airline stocks, the benefit of diversification increases. That is, investments that do not move in lockstep with each other reduce the volatility (risk) of an investor's overall portfolio. Diversification's goal is not to enhance returns—in fact, it does not even guarantee a profit—but to reduce risk.

For example, see the accompanying graph. The basic case of two assets that respond completely differently to external events is presented. However, when these perfectly uncorrelated assets are combined into one portfolio, the returns are much more consistent and stable (less risky).

In the short term, the benefit of diversification can be obscured by volatile markets. Correlations between different types of investments are not static and can change dramatically, which occurred during the financial crisis of 2008 – 2009.

In order to structure a diversified portfolio, you should use a combination of investments covering domestic stocks, including representation of large and small companies, value and growth-oriented stocks, as well as international stocks, including those of developed and developing countries. In the bond arena you should consider investing in domestic and international bonds of varying sensitivities to interest rate changes. Depending on your income level and the mix of your retirement and non-retirement assets, you may want to consider municipal, government, or corporate bonds.

Your overall asset allocation (another commonly used investment term that refers to the mix of stocks, bonds, cash, and other investments in a portfolio) and diversification strategy is dependent upon your individual goals, investment time horizon, risk tolerance, and related factors. These are the types of decisions we assist our clients with in structuring their portfolios.