

Benefits of Diversification

“Don’t put all your eggs in one basket” is a common expression that most have heard in their lifetime. It means don’t risk losing everything by putting all your hard work or money into any one place.

To practice this in the context of investing means diversification—the strategy of holding more than one type of investment, such as stocks, bonds, or cash, in a portfolio to reduce the risk. In addition, an investor can diversify among their stock holdings by buying a combination of large, small, or international stocks and their bond holdings by buying short-term and long-term bonds, government bonds, or high and low quality bonds.

A diversification strategy reduces risk because stocks, bonds, and cash generally do not react identically in changing economic or market conditions. Diversification does not eliminate the risk of experiencing investment losses; however, by investing in a mix of these investments, an investor may be able to insulate their portfolio from major downswings in any one investment.

Over the long run, it is common for a more risky investment such as stocks to outperform a less risky diversified portfolio of stocks, bonds, and cash. However, one of the main advantages of diversification is reducing risk, not necessarily increasing return. The benefits of diversification become more apparent over a shorter time period, such as the early 2000s. Investors that had portfolios composed only of stocks suffered large losses, while those that had bonds or cash in their portfolio experienced less severe fluctuation in the value of their portfolio.

Help protect your nest egg through diversification.