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What is diversification?

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WHAT DOES IT MEAN?

Diversification means not putting all your hard-earned money into one asset, but to spread it over a wide selection of assets.

There are many ways to diversify. For example, you may invest in different assets such as stocks, bonds, commodities and properties, across different countries.

You may also purchase a product that is already diversified, for example, an exchange-traded fund (ETF) that tracks an index which comprises many different assets.

WHY IS IT IMPORTANT?

Effective diversification eliminates company-specific risk from a portfolio. For example, if one stock does badly because the company lost a few contracts, but the other stocks are not affected and therefore do not move likewise, the impact of that one bad stock will be reduced by the good performance of other stocks.

For diversification to work, the assets should not be perfectly positively correlated – that is, they should not move in lockstep in the same direction.

Research has shown that a well-diversified portfolio offers a better reward to risk trade-off for investors.

IF YOU WANT TO USE THE TERM, JUST SAY:

Diversification helps to limit your exposure to any one asset or type of asset.

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