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Risk in Investments and the Importance of Diversification

Part 2

This is the continuation of a two-part series on Risk Diversification in Investments. Part 1, which discussed investment risks, is available at www.investorscorner.info or at www.dcsx.cw

"The beauty of diversification is it's about as close as you can get to a free lunch in investing."

Barry Ritholtz

In the previous article, we explored risk and found that it is defined simply as the chance of something bad happening. When we apply it to investments, the risk is the possibility that you will not earn what you expected on the money you have originally invested or worse, you might lose some or all your money.

This risk of loss exists for every single type of investment. There is absolutely no investment in the universe that is risk-free! ABSOLUTELY NONE! Anyone who tells you otherwise is either lying or don't know what they are talking about. Get to safer grounds! Actually, for some investments, say stocks, generally, the risk of losing your money is even greater than other investments like for example bonds. That is why you will hear investment professionals saying that stocks are riskier than bonds or an advisor would more likely recommend bonds to an investor who doesn't like to take risk or someone who is just starting out in investments.

Therefore, the wise investor will try and manage this risk of loss in such a way that the possibility of loss is reduced while the chance of earning a high profit is increased. This is where diversification comes in!

So, what exactly is diversification? Diversification is not putting all your eggs in one basket for fear that if something happens to that one basket, all the eggs might be lost. You do not want that! It is only wise, therefore, to have for example two or three or four baskets of eggs depending on what you can afford! Similarly, in investments, diversification is where an investor buys a variety of investments, for example, bonds, stocks, real estate, commodities like gold, painting etc, with the money available for investment. So, if the stock price falls, you will still be able to earn money on the bonds, gold, building or paintings that you might have in your portfolio. Diversification is quite simple and it is a widely used technique in investment to manage risk.

"Mutual funds have historically offered safety and diversification. And they spare you the responsibility of picking individual stocks."

Ron Chernow

Now I know what you are saying, I do not have the monies to buy so many different types of investments to get the diversification I may need. Not to worry, there is a solution to this. It is called a Mutual Fund. Mutual Fund is a special type of investments that are perfect for small investors. It is a professionally managed investment solution that pools money from many investors to purchase different types of securities, including commodities such as gold, bonds, securities, paintings, etc. A mutual fund is a pre-packaged diversified investment solution for all types of investors who want a one-stop shop for risk diversification.

There are many different types of mutual funds that offer some level of diversification – there are Mutual Funds that purchase different types of stocks, other mutual funds that buy different types of bonds and others that buy mixes of both stocks and bonds. There are funds that invest in securities that give you return on the majority of the top stocks listed on an exchange. Because Mutual Fund varies in terms of what they will buy, it is important to assess the types of securities that the Mutual Fund will invest in before buying into the Mutual Fund. A mutual fund is a perfect example of investment risk diversification at work!

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