The Importance of Diversification
By Steve Gilbertson

In the late 1990s, thousands of investors made millions in their retirement accounts investing only in company stock or the hot tech stock of the day. Of course, we all know what came next: As companies such as Enron and WorldCom collapsed, many investors saw their retirement accounts completely wiped out. In hindsight, no clearer lesson can be learned from their experience than the importance of diversification within a portfolio.

Diversification, at its most basic level, is the spreading of risk among several types of assets, for example, stocks, bonds, and cash. This can help you to limit your downside risk while still allowing you to potentially achieve sizeable returns within your account. There are three primary levels of diversification to consider using within your portfolio:

1. **Owning different types of asset classes** – This level is comprised of stocks, bonds, and cash.

2. **Owning different subcategories within these asset classes** – This takes into account size of the companies tied to the underlying securities (ex: Large-Cap, Mid-Cap, Small-Cap)

3. **Owning different stocks/bonds within each class/subcategory** – Because mutual funds own many different securities within each fund, they inherently have this level of diversification

(There are other categories of assets, including growth vs. value, and international vs. domestic. However, these categories are beyond the scope of our present discussion.)

A common mistake that many people make is assuming that because they own many different stocks or mutual funds, they are properly diversified. However, it is not enough to just own many different stocks/bonds/funds. To be properly diversified, the assets within your portfolio must be sufficiently spread among different asset classes and/or subcategories.

Each asset class and subcategory reacts differently within different market environments. However, it is usually difficult to predict which class/subcategory will perform best at any particular time. Therefore, it can be very beneficial to own many different classes/subcategories of assets in order to be in a position to benefit from that group which experiences the greatest gains.

It is very important to understand that diversification does not eliminate the potential for losses in your account. However, as noted above, it can serve to limit your downside risk, thereby preventing an Enron-like collapse in your account, while still allowing you to potentially achieve significant returns.

If you have questions about the diversification of your portfolio or this topic in general, contact Steve Gilbertson at sgilbertson@bryton.com or Dave Creighton, Jr. at dcreightonjr@bryton.com, or call them at 515.223.1601.

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