How Does Diversification Reduce Risk?

Description

For many investors, the most important consideration when investing is the potential return. After all, it is the returns which attract all investors to buying and selling shares. However, by focusing on risk, it may be possible to enhance the overall performance of a portfolio.

Multi-layered

While diversification in its simplest form is relatively simple, it can prove to be highly varied. For example, buying a number of different companies may reduce company-specific risk and guard against the effects of issues such as profit warnings and poor strategy within one organisation. However, even with a long list of different companies within a portfolio, an investor may still be exposed to a wide range of risks which can largely be diversified away.

Geographic risk

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For example, geographic risk presents a continuing problem even as globalisation advances. The returns in different economies have varied considerably in recent years, which means that an investment in a slower-growing economy may have had a large opportunity cost. As such, buying shares in companies which operate in multiple regions could be a means of reducing risk in future. Similarly, buying stocks which report in different currencies could be a means of reducing foreign exchange risk.

Cyclicality

Diversifying between stocks with different growth attributes is another means of reducing portfolio risk. In other words, some stocks may have earnings that have high positive correlation to the performance of the wider economy. This means that they may register wild swings in profitability during different parts of the economic cycle. Marrying them with more defensive stocks which have earnings that are less dependent on the wider economic outlook could mean less volatility for the investor, as well as more consistent returns.

Maturity and dividends

While all investors will have differing views on dividends, it can make sense to invest in a range of companies based on their maturity. In other words, owning some younger companies which offer higher growth, but that need to retain capital in order to grow, could be a sound strategic move for the long term. Likewise, owning mature stocks which require only a small portion of profit to be retained each year for growth could mean a more balanced portfolio. They could provide an income return for an investor which can then be reinvested in other shares.

Balance

Clearly, diversification does not eradicate all risks from a portfolio. Neither should it seek to simply match the returns of the wider index, since there would be little value in attempting to build a portfolio when a tracker fund could achieve the same return goal. However, by attempting to diversify key risks such as company-specific risk and geographic risk, while also having a mix of young and old companies, it is possible to generate a more attractive risk/return ratio for the long run.

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