Why Avoiding This Mistake Could Improve Your Chances of Making a Million

Description

While making a million from investing in the stock market is an achievable goal for most investors, there are numerous pitfalls that could derail your progress.

Among them is failing to diversify across a range of companies that operate in varied sectors and geographies. This leads to concentration risk, with the impact of one company's poor performance on the wider portfolio being high.

As such, ensuring that your portfolio is sufficiently diversified to withstand potential challenges across industries and geographies could lead to a larger nest egg in the long run.

Company-specific risk

Although it is not possible to diversify away the potential for the stock market to decline, reducing the impact of company-specific risk is very simple for any investor to achieve. Every additional company held within a portfolio reduces the impact of any one single stock's poor performance on the value of the wider portfolio. While the marginal benefit of additional holdings will decrease as their number rises, having 20-30 stocks within a portfolio could provide a balance between risk reduction and having the opportunity to beat the wider index.

Reducing company-specific risk is crucial for all investors because it is impossible to only buy stocks that rise in perpetuity. Even the very best investors, such as Warren Buffett, make mistakes every so often in terms of the companies they buy. For example, a business may suffer from the emergence of a new entrant, or its growth strategy may fall flat. For an investor who has a concentrated portfolio, this can present a significant problem for the wider portfolio's valuation. An investor who has a diverse range of companies is unlikely to suffer to the same degree.

Broader diversification

Simply having a large number of stocks in a portfolio may not be the right means of reducing overall risk. In fact, it may be more prudent to focus on the types of companies in your portfolio, as well as their industries and geographies, in addition to having a sufficiently large number of stocks.

For example, owning growth companies that all operate in the industrials sector in the UK may mean that a portfolio is highly exposed to a UK economic slowdown. It may be more prudent to instead have some defensive stocks, as well as companies that operate in a variety of regions and sectors. This may not only reduce risk, but allow you to access faster growth rates that could be produced by different industries and economies.

Takeaway

While it is tempting to focus your capital on the best stocks you can find, the reality is that all companies can experience difficult periods that lead to declines in their stock prices. As such, by diversifying, you can reduce risk and boost your return prospects over the long run. This could improve your chances of making a million.

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