Trading Basics Series

HOW DO I TRADE STOCKS.COM

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DIVERSIFYING YOUR PORTFOLIO

Traditional diversification is to reduce the risk involved in building a portfolio. Volatility is limited by the fact that not all asset classes or industries or individual companies move up and down in value at the same time or at the same rate. While this limits the rate of growth as well, it reduces the likelihood of substantial losses and allows for more consistent performance under a wide range of economic conditions.

In a nutshell, here's what diversification stands for:

It's a portfolio strategy in which you spread your money around among different investments in order to reduce the risk of loss from a decline in the investments. Its goal is to reduce the risk in a portfolio. When diversification is properly applied, then it is expected that volatility or fluctuations in portfolio value become subdued and limited. The act of diversification reduces a portfolio's swings as well as both upside and downside potential, thus allowing for more consistent performance under a wide range of economic conditions.

Different Diversification Strategies for Your Portfolio

#1 Diversify across asset classes.

The most common way to diversify is according to asset classes. When you employ an asset allocation strategy, you are controlling the level of risk that your money is exposed to since your funds are spread around across different forms of equities, bonds, cash and hard assets. Some common asset classes include:

* Equities
* Government bonds
* Corporate bonds
* Cash equivalents
* Real estate
* Currencies
* Gold

You can easily achieve diversification this way through mutual funds, index funds and target date funds.

#2 Diversify across asset class variants.

Within each asset class, you can practice further diversification. For instance, equities have many representations in the mutual fund world. Variants or subclasses refer to more granular characteristics of the asset class. Here are some examples:

Equities can vary according to:
* The size of companies represented in a "basket" (e.g. large vs medium vs small cap stocks)
* The way the stocks' prices move as the stocks chart their growth (e.g. growth vs value stocks)
* The geographical market in which the stock moves (e.g. domestic vs international)

Bonds can vary according to:
* Their maturity dates (e.g. short term vs long term bonds)
* their level of risk (e.g. junk bonds, anyone?)
* Who issues the bond (e.g. government vs corporate)
* How they pay out

Cash vehicles vary mostly according to rates of return and level of security offered, which are usually characteristics that are inversely proportional to each other. Generally, within the investment world, the higher the rate of return, the less stable the fund value is expected to be.

Note though that most of the time, you don't really need to seek this kind of detailed representation to achieve a well diversified portfolio, as positions in basic asset classes may be sufficient to lower your market risks.

#3 Diversify across securities or investments within each asset class

If you are buying mutual fund shares, then you are effectively diversifying across securities. By buying into a basket of securities via index funds, mutual funds, ETFs, managed funds and such, then you are automatically spreading your risk across the board.

#4 Diversify across industries and sectors.

If you are interested in following a particular sector or industry but do not want to put all your eggs into one company's stock, you can buy sector funds that specialize in a specific industry or stock group, such as financial stocks, gaming stocks, internet stocks, semi-conductor stocks and the like. You're diversified within a group, but still fairly concentrated within a sector.

#5 Diversify across financial institutions and fund families.

There are many financial institutions out there, from online stock brokers to mutual fund companies, banks and even insurance companies — all offering financial and investment products. But no institution is perfect. Your non-cash investments are not FDIC insured, so entrusting them to any one institution holds some risk, no matter how minuscule. Banks and institutions have folded in the past, and have been rocked by scandal on occasion. So it's something to keep in mind when you're putting your money on the line. There's a trade-off between desiring the convenience and organization of a consolidated portfolio in one location versus deploying your funds across various companies, or placing your eggs among various financial baskets on the Kiplinger's list of "favourite fund companies to buy into now".

#6 Diversify across fund managers.

Again, when you invest in various mutual funds, you are normally giving your money to different fund managers to invest. But it's not all too uncommon for the same people to be simultaneously heading multiple funds, as in the case of the same managers used for various international or foreign based funds in the same institution.

#7 Diversify across time horizons and levels of liquidity.

Based on your various goals, it's a good idea to maintain different levels of liquidity. For your short term goals such as funding a big ticket event (e.g.: wedding or travel) you're typically going to save using a cash account. For medium term goals, you can take some risk with blended funds for example, while for the longer term goals (e.g.: kids' college fund, retirement) you can be less liquid, by getting into more aggressive stocks or real estate.

#8 Diversify across time with dollar cost averaging (DCA).

A favourite diversification mechanism is by investing periodically across time. By buying stocks on a regular basis, you end up picking up stocks at a variety of prices as they fluctuate. In this case, if you're not confident about the market's movements, you may want to distribute your purchasing power throughout a specific time period. Note however, that there have been strong arguments that investing a lump sum in one fell swoop actually results in better returns compared to a DCA strategy. Historically, with markets marching higher, it turns out that you may be sacrificing a bit of your returns for that sense of "security" or assurance that you're not buying all at once at the "wrong time".

Conclusion

How does diversification relate to you? Well, fully diversified portfolios as described above are really for the big guys. Most retail investors and I'm sure this includes you, don't have millions to invest in the markets. So buying treasury's and "defensive stocks" like utilities to have a balanced portfolio just does not make sense. Fortunately we have the advantage of speed. It takes us about 3 seconds to enter and exit a trade, whereas, if you are a fund then it can take weeks to do the same.

As described in point #4, at HowDoITradeStocks.com we like to diversify through industries and sectors, for example we try not to be in more than one stock that is in the same industry e.g. Financials, Technology etc. This limits our risk, as big news that affects one of the leading companies in an industry can have a negative impact on every stock in the industry. We also focus on longer term goals as described in #7. We do this by only investing in the best growth stocks with the strongest fundamentals.

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