MODULE

Diversification & Risk

As an investor, it's important to never put all of your eggs in one basket. That's where diversification comes into play! Imagine if you had invested all of your money into restaurants before the Covid pandemic - or banks before the 2008 Financial Crisis... Not pretty.

When done correctly, diversification can reduce the risk portfolio faces and help capture returns from the broader market. Risk is unavoidable when you investing, but it declines over time; and that's where the real money can be made!

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Key Takeaways From Module 3

Guiding Questions

- What are the different types of risk?
- What is diversification and how does it reduce certain types of risk?
- What are the different strategies of diversification?
- What are the different asset classes available to investors?

Enduring Understandings

- How to diversify investments and reduce overall risk.
- Risk declines over the long-term.
- Time in the market is more valuable than timing the market.
- There's a whole world of financial instruments beyond stocks that provide leverage.

Key Terms About Diversification

Index Fund: An index fund is a “basket” of stocks that mimics major stock indices, such as the S&P 500 or Dow Jones index. Index funds generally follow the performance of the market as a whole.

Volatility: This refers to sudden downturns and upswings in the market or individual stocks; some stocks are less volatile than others, but volatility is always present in the market to some degree.

Mutual Fund: A mutual fund uses other investors money to create a portfolio of stocks with the goal of generating high returns. Individual investors can invest in mutual funds to diversify their portfolio.

Treasury Bonds: These securities are issued by the government and represent pieces of government debt. They are considered very safe investments, as they are backed by the government.

Commodities: This is an asset class that includes precious metals, grain, oil, corn, natural gas and other goods. Commodities generally have completely different returns than stocks and bonds, and are therefore helpful for portfolio diversification.

At The End Of The Day, It's All About Risk

And There's No Avoiding It!

All actions & investments have risk because no outcome has perfect certainty. However, you can control how much risk you are willing to take on for an anticipated return.

Some people approach finance (and life) as **risk averse**(reluctant to take risks) while others are more **risk-seeking** (willing to accept greater uncertainty in exchange for the potential of higher returns.)

Unsystematic Risk

Risk that only affects a certain firm or specific class of assets and can be eliminated through diversification.
Eg: Operating strategy of one company

Systematic Risk

Risk that affects the entire market and thus, cannot be diversified away. Often outside of companies' control.
Eg: taxation policies, inflation, interest rates

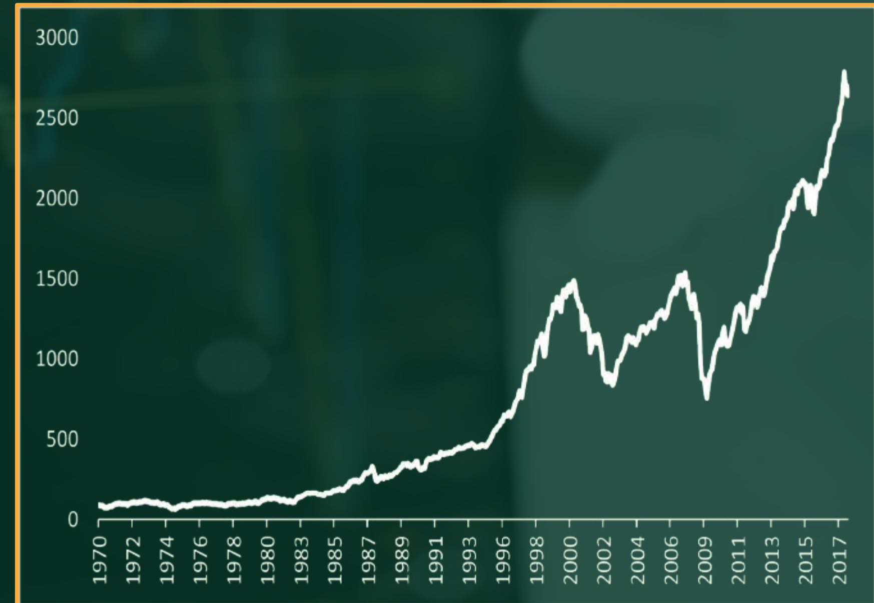
However, Risk Always Declines, Long-Term

Probability of losing money (risk) **declines** as time horizon increases. The growth of financial markets over time supports this theory. So, it is better to have **“time in the market”**.

If we think about it logically, this makes sense.

Over the long-term, the economy grows as the world's population increases and companies continue to innovate. This means that financial markets will trend upwards overtime, provided an investor waits long enough.

S&P 500 Historical Performance
(a proxy for a fully diversified portfolio)



What Diversification Is And Is Not

Diversification involves investing across an array of asset classes and investment vehicles to mitigate unsystematic risk. As some industries are inversely related, when one asset in a portfolio performs negatively there are other assets generating positive returns.

Diversification Involves...

Spreading money **across asset classes**. This may include stocks, bonds, real estate, ETFs, commodities, cash & short-term equivalents.

Spreading money **with an asset class**. This could look like investing in the stocks of different industries or different market caps.

Diversification Does Not Involve...

Investing in different companies in the same industry. This strategy exposes you to the **same unsystematic risk**.

Trying to completely eliminate investment risk. **This is impossible** since market risk (systematic risk) is undiversifiable

The Most Basic Form of Diversification: FETCH

Financial Services are the primary driver of an economy as they provides liquidity and fee-flowing capital to individuals and businesses alike

Energy relates to companies that produce and supply energy. It represents all aspects of oil, gas, coal, renewables and other consumable energy that power our daily lives and businesses

Technology encompasses businesses that sell goods and services in electronics, software, artificial intelligence which have revolutionized every industry

Communications represents companies that make communication possible on global scale through the phone or internet, wireless. It is critical to connectivity

Healthcare provide goods and medical services to treat patients, and develop drugs to eradicate diseases

Why FETCH Works

These 5 industries are essential to the market. They will be a stabilizing force in your portfolio even if the other industries are down

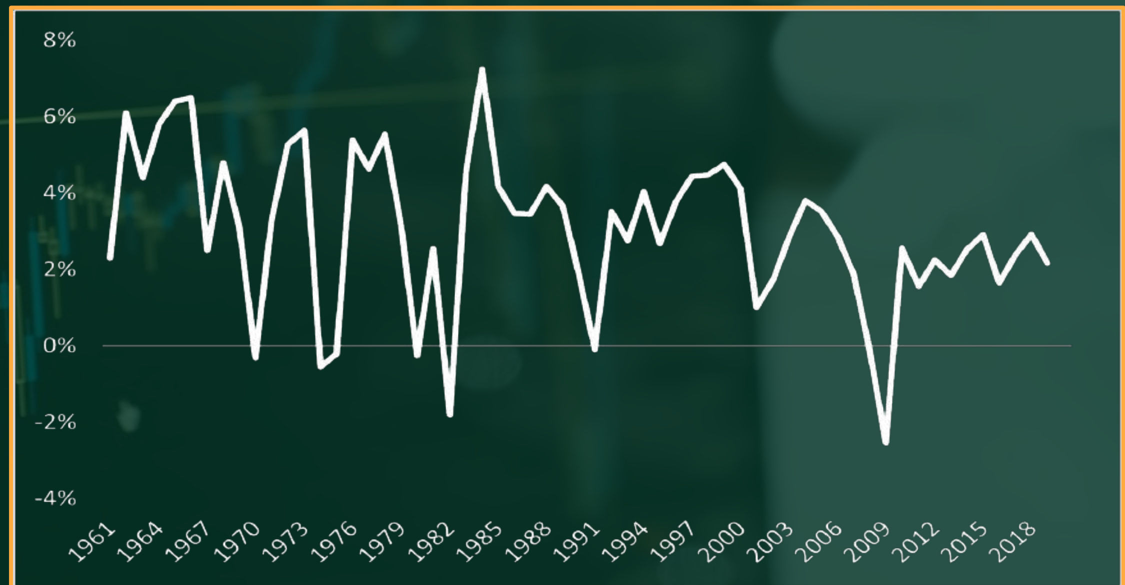
Diversifying By Owning The Whole Economy

Index investing is a common strategy where investors purchase a reflective benchmark such as the S&P 500 index allowing for diversification across companies in the index,

We can see there is **consistent productivity growth** in the economy since there are very few years with negative growth. You can tap into this consistent growth by **“owning the market”** through an index.

This strategy relies upon the fact that risk declines over the long-term and is a passive investment strategy.

50 year GDP growth rate: averages 2-3% annually

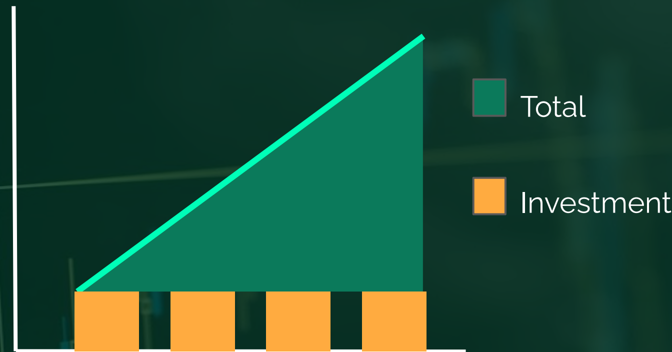


Diversify Your Cost With Dollar-Averaging

Dollar cost averaging is an investment strategy where an investor divides up the total amount to be invested across **periodic purchases** of a target asset in an effort to reduce the volatility of the entire purchase.

These purchases occur **regardless of asset's price** & at regular intervals.

Dollar Cost Averaging



Lump Sum Investing

Why Dollar Cost Averaging?

When we looked at the S&P 500, we saw that the market grows in the long run but there can be short run volatility. Dollar cost averaging takes advantage of this by working to build savings and wealth in the long term, while minimizing short term volatility of the market

Key Takeaways From This Module

CORE & FUNDAMENTALS

- There are various types of risk.
- Diversification is the best way to reduce risk.
- There are various asset classes outside of stocks available to investors such as commodities and real estate.

APPLIED KNOWLEDGE

- Different types of investments come with different levels of risk
- You can define the level of risk you are comfortable with using tests like the 100 Rule
- There are many avenues to hedge against risk.

RELEVANCE FOR YOU

- Risk declines over time with long term investments, but there is some risk that's unavoidable.
- Diversification can protect your overall portfolio from short-term market fluctuations.
- There's a whole world of financial instruments that extend beyond the stock market so you can spread your risk!