What is Diversification?

Investing Fundamentals

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Diversification is a strategy to help you manage your investment risks by spreading your money across a variety of investment vehicles and assets. The logic behind diversification is that by investing in a mix of assets (e.g., bonds, stocks, and ETFs), your portfolio won't fail if one investment breaks down. That's because different types of assets react differently to turbulences in the market.

Some assets perform better than others under certain market conditions. By diversifying, if one part of your portfolio isn't doing well, the other parts of your portfolio may be able to cushion the ups and downs of the market. Another important concept to understand is that the primary purpose of diversification isn't to maximize returns. Instead, it's to limit your exposure to certain investment risks. Diversification has the potential to improve your returns over time, but it does not guarantee any return on investment.

Diversification doesn't eliminate all risk

While diversification doesn't guarantee gains, it also doesn't protect against losses. Investing comes with risks, and these risks can never be eliminated. While spreading your investments around can offset certain portfolio losses caused by company-specific risks, diversification is usually unhelpful when it comes to facing down market-wide risks.

What are the building blocks of a diversified portfolio?

There are many ways to spread out your investments thanks to the many assets and investment vehicles that are available. To build a diversified portfolio, you can invest across asset classes, within an asset class and across industries.

When investors look to diversify across asset classes, a few types of assets generally come into play. These include stocks, bonds and short-term investments like money market mutual funds. A diversified portfolio typically contains a mixture of these investments.

You may also want diversification within a particular asset class. For example, when you buy stocks, you don't want to put all your money in a single company. This is where mutual funds and exchange-traded funds (ETFs) can be helpful. These funds contain a variety of bonds and stocks, so that diversification is automatic. For example, an S&P 500 index fund holds shares in the largest public companies in the U.S.

Investors who are interested in diversification may also look into sector funds, which focus investments in a particular industry sector. For instance, there are mutual funds that invest exclusively in energy companies. But be careful not to concentrate too heavily in any one particular sector. Again, the goal of diversification is to minimize your exposure to certain company-specific (or in this case, industry-specific) risks.

The bottom line

There's no simple strategy or one-size-fits-all plan to diversification. Know your investment goals before deciding on asset allocations. Discuss with your financial advisor and determine how to diversify your investments to achieve your goals within a given timeframe. As your investment goals change over time, so can your diversification strategy.

> We encourage you to reach out to your Goldman Sachs team if you have any questions.

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