Decoding Financial Jargon: Diversification

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This article is part 3 of a series attempting to teach the concepts of often misunderstood financial terms and phrases.

Stocks, bonds, equities, fixed income, mutual funds, asset allocation, dividends, diversification, the stock market. Our industry is filled with terms and phrases. What I've learned from thousands of meetings with clients over the past decade is that few people understand what these terms truly mean. Many people have heard and read them enough to be able to use them in a sentence, but almost no one understands them well enough to teach them to their children or make tough decisions regarding their finances. So, over the course of a few articles I'd like to share how I teach these concepts to my children, and hopefully shed some light for those who were never taught themselves.

Diversification is talked about as a surefire way to limit your risk when investing. But what does it really mean, what are the trade-offs, and how would you go about diversifying your investments?

"Don't put all your eggs in one basket." Is that the simple truth behind the term diversification? No. At least it's not the full picture. This "wisdom" has led to massive mistakes. Consider this example: Our financial planning team recently reviewed the investments of a hardworking family that had saved well for many years. Along the way they followed this mantra by "diversifying" their assets into a dozen accounts. The family personally selected the investments for some while others were professionally managed by investment firms. However, when we reviewed all of the investments together, we learned that the clients weren't actually diversified. Of course, the clients were shocked. "How could this be?" they wondered.

Obviously, they had not put all their eggs in one basket and yet were not diversified. How many different accounts you have does not equate to diversification. How many stocks or mutual funds or index funds also does not matter. In the words of one of my favorite financial authors and mentors, Nick Murray, "diversification simply means to me that I'll never own enough of any one sector/idea to make a killing in it, nor enough to get killed by it."

Working with this definition, let me first point out that diversification does not mean you can avoid risk or wild market swings (down or up). Choosing to diversify is admitting that the randomness of performance in the short-run of any single company or market sector (i.e. healthcare, energy, manufacturing, etc.) is unknowable. The good news is that you don't have to know this to be a patient, successful, long-term investor. I'd also like to point out that this definition also concedes that limiting the downside risk (getting killed) also limits the upside potential (making a killing).

Diversification is for people who admit it's impossible to know the unknowable, and who desire to diligently work toward financial goals that are meaningful and real (not invest "to make a killing"). If this is you and you're unsure how to evaluate your own portfolio, go now and email or call a CERTIFIED FINACIAL PLANNER ™ practitioner to schedule a meeting and get started.