Diversification vs. Asset Allocation

Diversification and asset allocation allow individuals to spread their investments to protect against harsh changes in the market. A varied balance in an investment portfolio can lessen one's risk and maximize returns.

Diversification is an investment strategy involving a wide variety of investments in a portfolio in order to mitigate the exposure risk of a single asset. A positive performance in one asset will neutralize the negative performance of others, allowing an investor to maximize profit.

For example, an investor has $3,000 invested in stocks. After a year, this investor can determine the result of their investments. The chart below indicates this investor was able to make average returns on two of the investments but had a below-average rate of return on the remaining investment. Since the investor utilized the diversification strategy, the success of two investments was able to mitigate the less desirable outcome of one.

	Initial	Percentage Return	Total After One Year
AAPL. (Apple Inc.)	$1,000	13.6%	$1,136
GE (General Electric Company)	$1,000	.89%	$1,008.90
NKE (Nike, Inc.)	$1,000	9.6%	$1,096

Asset allocation is an investment strategy to choose the percentage of investments in various types of assets, such as stocks, bonds, cash, commodities and real estate, based on an individual's time horizon and risk tolerance. A time horizon refers to the time when an individual would need the money. Shorter time horizons do not tolerate as much risk as a longer time horizon, like saving for retirement. Risk tolerance is the individual's acceptance of potential short-term loss for long-term gain.

An individual's risk tolerance can change, which would alter the percentages allocated to the available asset categories. As risk tolerance is lowered, investments in less volatile categories will rise because an individual needs their returns to be more predictable.

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For example, after opening a Roth IRA account with $10,000, an investor decides to put 90 percent of their money in stocks and 10 percent in bonds. After a year, this investor will have to re-balance their assets, as their return equates to 15 percent in stocks and just 3 percent in bonds. To maintain the original allocation of a 90/10 percentage, this investor will now need to sell $108 of their investments in stocks to bonds.

	Initial	Percentage Return	Total After One Year
Stocks	$9,000	15%	$10,350
Bonds	$1,000	3%	$1,030
Total Investment:	$10,000		$11,380