

Diversification is one of the most important investing concepts. In its simplest form, it means to spread your investing dollars across different types of investments in order to reduce portfolio risk. During the financial crisis from late 2008 through early 2009, investors were shocked that portfolios fell 40-60%. They thought they had diversified portfolios because they had many investments. While it may have been difficult to avoid some losses during such a time, it was possible to avoid jaw-dropping losses with a truly diversified portfolio. Here are three misperceptions that can lead to poorly diversified portfolios.

Misperception	Commentary	Solution
More Investments Increase Diversification	<ul style="list-style-type: none"> Having many mutual funds or securities in your portfolio may reduce the risk that a single investment sinks your portfolio, but it doesn't reduce the risk of being concentrated in asset classes that suffer significant declines. The problem is that investments in the same asset class are highly correlated with one another, meaning that they tend to go up or down at the same time. 	<ul style="list-style-type: none"> Check the level of correlation of your investments Consider adding less correlated investments from other asset classes to improve diversification
Different Account Types Equals Diversification	<ul style="list-style-type: none"> Some investors believe that because they have different types of accounts such as a brokerage account, 401(k) plan, a variable annuity or a IRA that they are diversified. It is very likely that these underlying investments are similar and thus share some of the same risks. 	<ul style="list-style-type: none"> Look past the type of account to the underlying investments to understand what you own Take steps to increase diversification and optimize asset location
Diversification Can Be Measured with a Risk Statistic	<ul style="list-style-type: none"> Investors often define risk as a statistic like standard deviation. It is meant to convey how past investment returns have varied over time with the assumption that future returns will follow historical patterns. Unfortunately, it provides an illusion that risk can be measured precisely. Risk is a multi-faceted concept that cannot be reduced to a single statistic. 	<ul style="list-style-type: none"> Redefine risk as the likelihood of a significant loss. Construct your portfolio such that it will have an acceptable risk tolerance during a bear market in equities

Rethinking diversification and redefining risk is critical to your portfolio. If you need a little spiritual encouragement, the New Living Translation of Ecclesiastes 11:2 instructs us to "but divide your investments among many places for you do not know what risks lie ahead."