



Invest

The Importance of Diversification

Investment prices go up and down all the time. Although this “volatility” is a fact of life, it can make even seasoned investors nervous. Economic reports, changes in interest rates, and even rumors can send stock prices on a wild ride on any given trading day.

There is a way to help cushion investments against the stock market’s unpredictability. It’s a strategy called *diversification*, and it calls for having several different investments in a portfolio.

How Diversification Works

Diversification can help manage exposure to the risk of investment loss. When someone owns several investments and one of them is performing poorly, the other investments may help cushion the impact, even if they just hold steady. Diversification does not guarantee a profit, and you could still lose money in a declining market.

“Investing in a mutual fund offers automatic diversification . . .”

Investing in a mutual fund offers automatic diversification because funds hold numerous investments — sometimes hundreds of them. A fund that invests in companies representing different industries rather than just one sector provides additional diversification.

Diversifying Across Asset Classes

Investing among different investment types (asset classes) adds an additional level of diversification since the asset classes often react differently to economic changes. Bonds often hold steady when stocks are dropping, for example, and vice versa. So including bonds and cash equivalents in an investment mix can help reduce overall portfolio risk and volatility. Buying different types of bond funds or other income investments with varying maturity dates carries the idea of diversification even further.

The Asset Allocation Decision

The decision about how much money to invest in stocks, bonds, and cash equivalents will depend on two important factors: a person’s ability to handle investment risk and the time available for investing the money. Stocks potentially provide the highest returns, but they also involve the greatest risk of loss. Bonds offer lower potential returns and lower risk. There’s little chance of losing money with cash equivalents. But there’s still a risk: returns may be so low that they barely keep up with inflation.



Lifecycle Funds Take Care of Allocation Decisions

Lifecycle funds offer an easy and effective way to achieve diversification. With a lifecycle fund, investment professionals create a diversified portfolio designed to meet the common needs and goals of a specific group of people.

Target date retirement funds are one example. They provide a diversified

portfolio that is appropriate for people with a certain target date for retirement. As the date draws closer, the mix of stocks and bonds is automatically adjusted. Lifecycle funds eliminate the need to make asset allocation decisions; so they're a good option for people who don't have the time — or the desire — to monitor their investments.

A Smoother Investment Ride

Notice that the diversified portfolio in this graphic (Portfolio B) does not increase in value as much as the all-stock portfolio (Portfolio A) when the stock market rises. However, it loses less value when the stock market drops. The bottom line is that a diversified portfolio generally offers a smoother ride over the long-term than a portfolio that holds only one asset class.

	Portfolio A	Portfolio B
	<i>100% Stocks</i>	<i>50% Stocks 50% Bonds</i>
Initial Value	\$500	\$500
Value After Stock Prices Rise 10%	\$550	\$525
Value After Stock Prices Drop 10%	\$450	\$475

This is a hypothetical example that assumes that bond prices remain constant. It does not represent the results of any periodic investment plan in any portfolio. Different investments may perform better or worse than those in this example.

Source: NPI

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