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fall 2001

market mentor

Diversification

You might have heard the old expression, “Don’t put all your eggs in one basket.” Pouring everything you own (eggs) into one source (basket) could prove disastrous. If something happens to the basket, you have lost everything. This rule also applies to investing in stocks, and it is called *diversification*.

Diversifying your investment portfolio involves spreading your money across a variety of sectors. That way, if one industry is suffering financially, other areas may be experiencing fantastic gains and will balance out any losses.

Why does this matter? Do you remember the Nasdaq stock market crash in the spring of 2000? From March 10 to April 14, the Nasdaq lost nearly 40 percent of its value. The biggest decliners of that period were from the technology sector. Tech stocks had been the market leader for some time. When the bottom dropped out of the industry, many companies experienced devastating losses. If you had had all of your investments in tech stocks (and many investors did) you would have lost a great deal of money.

Diversifying your investments can reduce your exposure to risk. How much diversity do you need in your portfolio? That is hard to say. Experts agree that investment diversification is important. However, they cannot agree on what the best number of different investments is. Instead they suggest considering other points when choosing securities for your portfolio.

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DEFINE YOUR INVESTMENT GOALS.

Are you saving for a car? College tuition? A special trip? Each of these goals has different time horizons. Choosing a “hot” stock may make you money quickly, but you could also lose it just as quickly. If you are counting on that money to be there for you in the near future, you may want to choose a less risky investment. However, if you are saving for a long-term goal like retirement, you may want to ride out the roller coaster ride of the stock market.

What are your investment goals? _____

CHOOSE QUALITY OVER QUANTITY.

What is important is not *how many* stocks you own, but what kinds of stocks you own. Many investors, rather than dealing with diversification to reflect their investment objectives, sometimes view diversification as accumulating as many stocks as possible without considering what they are buying. As a result, a significant portion of their portfolio could be inappropriate for their strategy.

Name two stocks that would meet your investment goals.

CONSIDER ECONOMIC CYCLES.

The economy runs in cycles. Some companies flourish and suffer at the hands of the economic cycle. These stocks, known as cyclical

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Diversification

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stocks, are securities that rise quickly when the economy is on the upswing and fall when the economy drops. Examples include car manufacturing companies and toy companies. Non-cyclical stocks are companies that produce items people need regardless of the state of the economy, such as food and drugs.

Name a stock that is on an upswing now. _____

Name a stock that has remained stable (non-cyclical).

AVOID DUPLICATION.

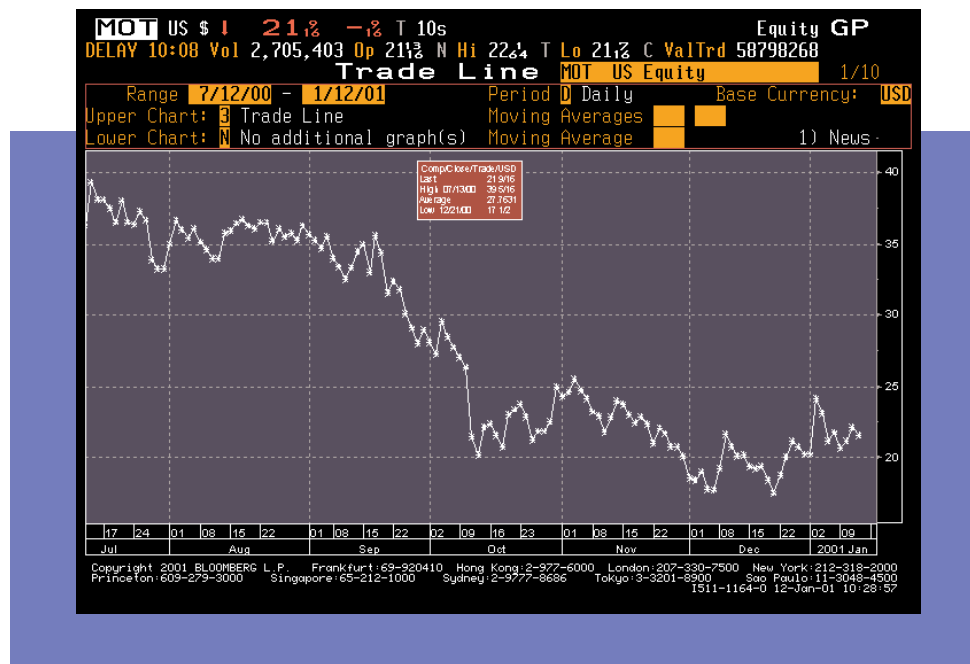
Choose stocks from a variety of industries. You may like The Gap (GPS) and The Limited (LTD) but if you are trying to diversify your portfolio, buying both of these securities may not be a wise choice. If the retail industry goes into a slump, so may your investments. List two industries that would not overlap for investing purposes.

The key to effective diversification is always to verify that each fund fulfills a separate and distinct purpose for your investment goals. Consider the type of company when choosing to invest.

An easy way to achieve a diverse portfolio is to invest in mutual funds. A mutual fund is an investment company that pools individual, institutional, and other investors' money and invests it in a variety of securities or markets. Spreading the investment over a variety of stocks and a variety of sectors helps reduce risk because if one area is doing poorly, another area may be flourishing. Watch out. If you own shares in several mutual funds, be sure to take a look at the holdings within each fund. Make sure you are not duplicating your efforts. For example, if you owned both Vanguard 500 Index Fund (VFINX) and Schwab 1000 Fund (SNXFX), you would own shares in many of the same companies. If trouble strikes these companies, both funds will have poor returns.

Investing in the stock market always involves some level of risk. But if you diversify your portfolio by buying shares in a variety of different types of companies, riding out the bumps of the stock market may be a little easier.

This is a graph of Motorola, Inc. and what has happened to the price of its stock from July 2000 to January 2001.





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TEACHERS' LESSON PAGE

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Instructions for teachers

FIRST:

ADMINISTER THIS QUICK QUIZ:

1. What is diversification?
2. Why is it important for investing?
3. Name one method of investing to achieve a diverse portfolio

THEN:

DISCUSS ANSWERS WITH THE CLASS.