Why diversification matters

It is one way to balance risk and reward in your investment portfolio by diversifying your assets.

Beginner Economic insights Mutual funds

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Diversification is the practice of spreading your investments around so that your exposure to any one type of asset is limited. This practice is designed to help reduce the volatility of your portfolio over time.

One of the keys to successful investing is learning how to balance your comfort level with risk against your time horizon. Invest your retirement nest egg too conservatively at a young age, and you run the risk that the growth rate of your investments won't keep pace with inflation. Conversely, if you invest too aggressively when you're older, you could leave your savings exposed to market volatility, which could erode the value of your assets at an age when you have fewer opportunities to recoup your losses.

One way to balance risk and reward in your investment portfolio is to diversify your assets. This strategy has many complex iterations, but at its root is the simple idea of spreading your portfolio across several asset classes. Diversification can help mitigate the risk and volatility in your portfolio, potentially reducing the number and severity of stomach-churning ups and downs. Remember, diversification does not ensure a profit or guarantee against loss.

The 4 primary components of a diversified portfolio

Domestic stocks

Stocks represent the most aggressive portion of your portfolio and provide the opportunity for higher growth over the long term. However, this greater potential for growth carries a greater risk, particularly in the short term. Because stocks are generally more volatile than other types of assets, your investment in a stock could be worth less if and when you decide to sell it.

Bonds

Most bonds provide regular interest income and are generally considered to be less volatile than stocks. They can also act as a cushion against the unpredictable ups and downs of the stock market, as they often behave differently than stocks. Investors who are more focused on safety than growth often favor US Treasury or other high-quality bonds, while reducing their exposure to stocks. These investors may have to accept lower long-term returns, as many bonds—especially high-quality issues—generally don't offer returns as high as stocks over the long term. However, note that some fixed income investments, like high-yield bonds and certain international bonds, can offer much higher yields, albeit with more risk.

Short-term investments

These include money market funds and short-term CDs (certificates of deposit). Money market funds are conservative investments that offer stability and easy access to your money, ideal for those looking to preserve principal. In exchange for that level of safety, money market funds usually provide lower returns than bond funds or individual bonds. While money market funds are considered safer and more conservative, however, they are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) the way many CDs are.* When you invest in CDs though, you may sacrifice the liquidity generally offered by money market funds.

*** You could lose money by investing in a money market fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Fidelity Investments and its affiliates, the fund's sponsor, have no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.**

International stocks

Stocks issued by non-US companies often perform differently than their US counterparts, providing exposure to opportunities not offered by US securities. If you're searching for investments that offer both higher potential returns and higher risk, you may want to consider adding some foreign stocks to your portfolio.

Additional components of a diversified portfolio

Sector funds

Although these invest in stocks, sector funds, as their name suggests, focus on a particular segment of the economy. They can be valuable tools for investors seeking opportunities in different phases of the economic cycle.

Commodity-focused funds

While only the most experienced investors should invest in commodities, adding equity funds that focus on commodity-intensive industries to your portfolio—such as oil and gas, mining, and natural resources—can provide a good hedge against inflation.

Real estate funds

Real estate funds, including real estate investment trusts (REITs), can also play a role in diversifying your portfolio and providing some protection against the risk of inflation.

Asset allocation funds

For investors who don't have the time or the expertise to build a diversified portfolio, asset allocation funds can serve as an effective single-fund strategy. Fidelity manages a number of different types of these funds, including funds that are managed to a specific target date, funds that are managed to maintain a specific asset allocation, funds that are managed to generate income, and funds that are managed in anticipation of specific outcomes, such as inflation.

How diversification can help reduce the impact of market volatility

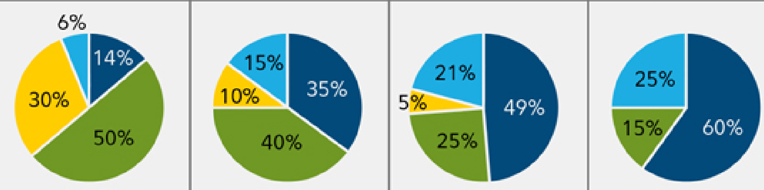
The primary goal of diversification isn't to maximize returns. Its primary goal is to limit the impact of volatility on a portfolio. To better understand this concept, look at the charts below, which depict hypothetical portfolios with different asset allocations. The average annual return for each portfolio from 1926 through 2015, including reinvested dividends and other earnings, is noted, as are the best and worst 20-year returns.

The most aggressive portfolio shown comprises 60% domestic stocks, 25% international stocks, and 15% bonds: it had an average annual return of 9.65%. Its best 12-month return was 136%, while its worst 12-month return would have lost nearly 61%. That's probably too much volatility for most investors to endure.

Changing the asset allocation slightly, however, tightened the range of those swings without giving up too much in the way of long-term performance. For instance, a portfolio with an allocation of 49% domestic stocks, 21% international stocks, 25% bonds, and 5% short-term investments would have generated average annual returns of almost 9% over the same period, albeit with a narrower range of extremes on the high and low end. As you can see when looking at the other asset allocations, adding more fixed income investments to a portfolio will slightly reduce one’s expectations for long-term returns, but may significantly reduce the impact of market volatility. This is a trade-off many investors feel is worthwhile, particularly as they get older and more risk-averse.

The impact of asset allocation on long-term performance and short-term volatility

US stock
Foreign stock
Bond
Short-term investments



	Conservative	Balanced	Growth	Aggressive growth
Annual return %				
Average annual return	5.96%	7.96%	8.97%	9.65%
Best 12-month return	31.06%	76.57%	109.55%	136.07%
Worst 12-month return	–17.67%	–40.64%	–52.92%	–60.78%
Best 20-year return (annualized)	10.98%	13.83%	15.34%	16.49%
Worst 20-year return (annualized)	2.92%	3.43%	3.10%	2.66%

Asset mix performance figures are based on the weighted average of annual return figures for certain benchmarks for each asset class represented. Historical returns and volatility of the stock, bond, and short-term asset classes are based on the historical performance data of various indexes from 1926 through the most recent year-end data available from Morningstar. Domestic stocks represented by S&P 500 1926 – 1986, Dow Jones U.S. Total Market 1987–most recent year end; foreign stock represented by S&P 500 1926 – 1969, MSCI EAFE 1970 – 2000, MSCI ACWI Ex USA 2001 – most recent year end; bonds represented by U.S. intermediate-term bonds 1926 – 1975, Barclays U.S. Aggregate Bond 1976 – most recent year end; short term represented by 30-day U.S. Treasury bills 1926 – most recent year end. It is not possible to invest directly in an index. Although past performance does not guarantee future results, it may be useful in comparing alternative investment strategies over the long term. Performance returns for actual investments will generally be reduced by fees and expenses not reflected in these investments' hypothetical illustrations. Indexes are unmanaged .Generally, among asset classes, stocks are more volatile than bonds or short-term instruments and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Although the bond market is also volatile, lower-quality debt securities, including leveraged loans, generally offer higher yields compared with investment-grade securities, but also involve greater risk of default or price changes. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets..

Factoring time into your diversification strategy

People are accustomed to thinking about their savings in terms of goals: retirement, college, a down payment, or a vacation. But as you build and manage your asset allocation—regardless of which goal you're pursuing—there are 2 important things to consider. The first is the number of years until you expect to need the money—also known as your time horizon. The second is your attitude toward risk—also known as your risk tolerance.

Feedback

For instance, think about a goal that's 25 years away, like retirement. Because your time horizon is fairly long, you may be willing to take on additional risk in pursuit of long-term growth, under the assumption that you'll usually have time to regain lost ground in the event of a short-term market decline. In that case, a higher exposure to domestic and international stocks may be appropriate.

But here's where your risk tolerance becomes a factor. Regardless of your time horizon, you should only take on a level of risk with which you're comfortable. So even if you're saving for a long-term goal, if you're more risk-averse you may want to consider a more balanced portfolio with some fixed income investments. And regardless of your time horizon and risk tolerance, even if you're pursuing the most aggressive asset allocation models, you may want to consider including a fixed income component to help reduce the overall volatility of your portfolio.

The other thing to remember about your time horizon is that it's constantly changing. So, let's say your retirement is now 10 years away instead of 25 years—you may want to reallocate your assets to help reduce your exposure to higher-risk investments in favor of more conservative ones, like bond or money market funds. This can help mitigate the impact of extreme market swings on your portfolio, which is important when you expect to need the money relatively soon.

Once you've entered retirement, a large portion of your portfolio should be in more stable, lower-risk investments that can potentially generate income. But even in retirement, diversification is key to helping you manage risk. At this point in your life, your biggest risk is outliving your assets. So just as you should never be 100% invested in stocks, it's probably a good idea to never be 100% allocated in short-term investments if your time horizon is greater than one year. After all, even in retirement you will need a certain exposure to growth-oriented investments to combat inflation and help ensure your assets last for what could be a decades-long retirement.

Regardless of your goal, your time horizon, or your risk tolerance, a diversified portfolio is the foundation of any smart investment strategy.

Next steps to consider

Open an account

Invest in mutual funds from hundreds of fund companies.

Get a financial checkup

Answer 9 questions to get a financial wellness plan.

Choosing investments wisely

How to employ a methodical approach to asset allocation.

Past performance is no guarantee of future results.

Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Your ability to sell a CD on the secondary market is subject to market conditions. If your CD has a step rate, the interest rate may be higher or lower than prevailing market rates. The initial rate on a step-rate CD is not the yield to maturity. If your CD has a call provision, which many step-rate CDs do, the decision to call the CD is at the issuer's sole discretion. Also, if the issuer calls the CD, you may obtain a less favorable interest rate upon reinvestment of your funds. Fidelity makes no judgment as to the creditworthiness of the issuing institution.

Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Asset allocation and diversification do not ensure a profit or guarantee against a loss.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

Changes in real estate values or economic conditions can have a positive or negative effect on issuers in the real estate industry.

The commodities industry can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

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