

# Diversification and Discipline:

## Two principles that Every Investor Should Follow

Most money managers would agree that the most important investment principle is diversification, yet failing to ensure a portfolio is well diversified is one of the most common investing mistakes. While many believe that picking the right stock is the key to success, a significant portion of the growth of long-term portfolios can be attributed to the diversification of the assets held within the portfolio. Simply put, diversification ensures that you spread your eggs into enough baskets to reduce your exposure to any single event, industry or company.

For example, suppose the only stock you hold is that of an oil company and the price of oil drops sharply; the losses you will suffer will be significant. But now, suppose you add the stock of a shipping company as a second security to your portfolio. As the price of oil falls, the shipping company's costs are reduced thereby improving profits and subsequently the stock price. The losses from the oil company will be offset by the gains of the shipping company. The opposite scenario will play out if the price of oil happens to increase significantly. Either way, the two-stock portfolio you have constructed provides some protection against the economic shock of a large swing in the price of oil. Absent of such an event, both companies should be able to manage their businesses profitably and your portfolio will continue to enjoy modest gains from both of the stocks it holds.

A properly diversified portfolio will ensure exposure to all major sectors of the economy throughout the dif-

ferent geographic regions of the world thereby mitigating the risks associated to any specific industry sector, region or individual stock.

Even the best-devised investment strategy with assets properly diversified is susceptible to failure if the money manager lacks the discipline to execute and stick to the plan. Many of our subconscious psychological responses to specific situations result in mistakes detrimental to investment performance. Having a disciplined approach reduces the likelihood of making poor rash decisions. Take for instance the common wisdom of buy low / sell high. In theory this is easy to say; however, in practice, without discipline it is hard to execute. It is through discipline and adherence to a well-planned investment strategy where an investor can avoid many of the common psychological mistakes. Defining target ranges for specific asset classes and economic sectors combined with rebalancing keeps the portfolio onside with the plan. This forces the selling or trimming of securities as they rise in price relative to others.

Once again by using a simple example, the importance of discipline can be illustrated. Suppose that you have decided that maintaining a target allocation of 50% bonds and 50% stocks is an appropriate mix to meet your investment objectives. With \$100,000 in your portfolio, you proceed to purchase \$50,000 of bonds and \$50,000 of stocks. Say that the stocks rises in value by 20% following a period of positive returns

for equity markets. The stocks have grown in value to \$60,000 and now represents 54.5% of your portfolio now valued at \$110,000. As a disciplined investor you should sell \$5,000 of the stock and purchase an additional \$5,000 in bonds, maintaining your 50/50 target. A disciplined approach to the management of your portfolio has forced you to trim the stocks after increasing in relative value. Conversely, should equity markets decline you would sell a portion of the bonds, effectively forcing you to buy stocks at lower prices.

While one can never avoid all risks inherent in financial markets, diversification and discipline can assist with managing some of those risks to help ensure that your investments meet your goals and objectives over time.

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