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What does portfolio diversification actually mean?

CENTRAL, HONG KONG, HONG KONG, May 29, 2023 /EINPresswire.com/ -- What exactly does an idea financial portfolio look like? There is no one answer to this question, because when building an investment portfolio, competent investment professionals will always try to balance risk and return opportunities in a way that corresponds with a person's individual needs.

Diversification plays a very important role in efficient asset allocation.

Diversification is a key component of Harry Markowitz's Modern Portfolio Theory. Markowitz received the Nobel Prize for this model, which he developed in the early 1950's. Today, he is considered the father of efficient asset allocation.

Put simply, diversification means not putting all your eggs in one basket. But that isn't something that investors should do intuitively. Instead, you need to distinguish between systematic and unsystematic risk.

Systematic risk is the risk of fluctuations in the broader capital markets and cannot be reduced through diversification. If you have a portfolio that initially consists exclusively of one stock, and the investor then diversifies this portfolio by investing globally in 20 different stocks, the unsystematic risk can ideally be reduced by more than 90 percent.

The term broad diversification generally refers to allocating assets according to various criteria, including different asset classes, sectors, countries, currencies and other factors. The reason for doing this is to reduce risk and achieve a better return.

The goal of asset allocation is to invest in different portfolio components with a low or negative correlation. This is done in an effort to ensure that fluctuations in one asset class or asset component do not impact the other elements of the portfolio.

Ultimately, the aim is to offset potential losses in individual asset classes, sectors or currencies with gains in other areas through the skillful allocation of assets. This can improve the stability of the overall portfolio and increase the risk-adjusted expected return.

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