OSC ONTARIO SECURITIES COMMISSION

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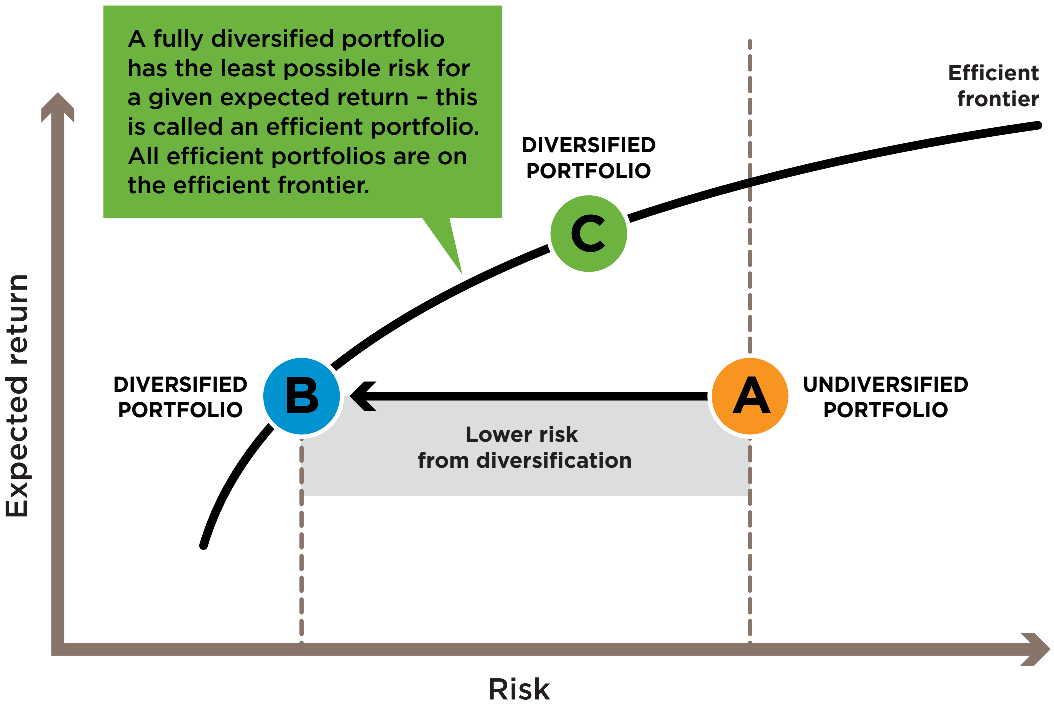
Risk and diversification

If you hold a portfolio with a variety of different investments, not all of the investments will perform the same way at the same time. Diversification lets you reduce the risk of your portfolio without sacrificing potential returns. As you diversify by adding more and different investments to a portfolio, you lower your potential risk of loss.

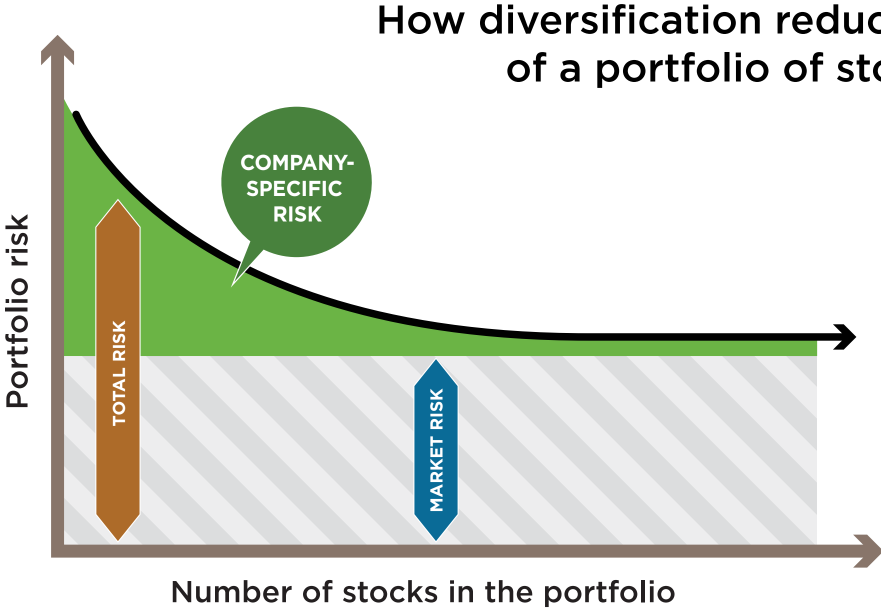


A **Undiversified portfolio:** Exposed to too much potential risk for too little possibility of reward

B **Fully diversified portfolio:** The least possible risk for the same expected returns as in Portfolio A

C **Fully diversified portfolio, greater expected return:** More risk

How diversification reduces the risk of a portfolio of stocks



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A fully diversified portfolio has the least possible risk for a given expected return. This is called an efficient portfolio. All efficient portfolios lie on the efficient frontier. The efficient frontier is a positive sloping line in the graph plane that identifies risk on its x-axis with expected return on its y-axis.

An individual with an undiversified portfolio is exposed to too much potential risk for too little possibility of reward. This portfolio is not on the efficient frontier line. When you have a fully diversified portfolio, you are located on the efficient frontier line and can adjust expected return based on how much risk you are willing to take.

You can't completely eliminate all investment risk from a portfolio. For example, after diversification of a portfolio of stocks, you're still left with overall market risk – the movement of the entire market that typically affects all individual stocks.

In a portfolio of stocks, your exposure to market risk will remain constant, but by diversifying through adding different stocks, you are able to decrease company-specific risk. Diversification reduces the risk in a portfolio because the greater number of stocks you have in the portfolio, the less invested you are in a single stock or company.