ACTIVITY 18.1
GET DIVERSIFIED!

Diversification Part 1: Reducing the Risk of Buying Stocks

Diversification means replacing a single risk with a large number of smaller risks. The basic idea is as simple as the old adage, "Don't put all your eggs in one basket." While diversification appears to be a simple idea, however, it has important implications for investing in stocks and in obtaining protection against various personal losses.

All investment choices involve risk. One type of risk is market-price risk. Market-price risk is the risk that you could lose all of an investment if the market price of the asset—say, 100 shares of stock—declined to zero.

One way to reduce market-price risk is to diversify investments across different categories of assets. This is called *asset diversification*. It means spreading your investment funds out over various investment options such as stocks, bonds, and mutual funds.

The concept of diversification can also be applied to buying stocks. If you buy stock in many companies, the risk of losing all of your investment is reduced. Any given set of stocks—such as technology companies—might perform poorly in a given period of time. However, the idea of stock diversification is that a decline in technology stocks would be balanced out by gains within another group of stocks—perhaps stocks in health care companies. Diversification can help cushion investors against wide swings in stock prices.

Possibilities for diversification in stocks include holding stock in companies that differ along these lines:

- **Sizes**—some large companies, some mid-sized companies, and some small companies.
- **Sectors of the economy**—perhaps some technology companies, manufacturing companies, pharmaceutical companies, and utility companies.
- **Locations**—perhaps companies in the United States and in Canada, Europe, Asia, and South America.

Questions for Discussion

A. What is diversification?

B. What is market-price risk?

C. What is diversification as applied to purchasing stocks?

Diversification Part 2: Reducing Risk by Buying Insurance

Market-price risk is only one risk out of many. People routinely face the risk of losses arising from several other sources. They have car accidents and are victims of robberies. Their homes and cars are damaged in hail storms and floods. They suffer from illness and disability, and they die. Buying insurance is one way to reduce the financial losses that follow when these bad things happen.

The Home Owners of Valley View Estates Learn How Insurance Works

This story tells how the residents of Valley View Estates learned about insurance. Valley View Estates is a housing development serving 500 home owners. These homeowners learned that insurance spreads risks out over a group of people. It provides a way of diversifying risk.

Valley View Estates comprises 500 homes, a playground for little kids, a club house, and a swimming pool. It is home to 500 home owners and their families, 99 dogs, 68 cats, and one pet snake that everyone hopes never escapes.

Valley View Estates has a Home Owners' Association that takes responsibility for providing services to home owners—making sure that lawns are watered in the summer, snow is plowed in the winter, and so on.

Tom Mulligan is President of the Home Owners Association. He thinks he has a plan for how Valley View homeowners might be able to save some money. But in order to explain it, he will have to make sure the Board members understand how insurance works.

Tom has called a meeting of Valley View Estates Home Owners Association Executive Board. Serving on the Board with Tom are Alicia, Sam, and Roland.

Tom Calls the Meeting of the Board to Order

Tom: Welcome everyone. Thanks for coming. I have an idea that I think could save Valley View Estates residents a few bucks. Do you mind if I tell you about it?

Alicia: Not at all, Tom. You know I am always interested in saving a few bucks. What's on your mind?

Tom: You know that buying a home is the biggest investment many people ever make. That certainly is true of the good folks living here in Valley View Estates.

Sam: That's true, Tom. Our homes are very important to us. That's why everyone here has homeowners' insurance. They have that insurance to protect themselves against damage or loss from things such as fire, lightning, or theft.

Tom: That's right, Sam. I was wondering about this angle on insurance: if we purchased home owners insurance as a group, could we save some money?

Roland: Tom, could you tell us how homeowners' insurance actually works? I think a lot of our home owners are confused about that. They just pay their insurance bills—I think they are called premiums—without paying much attention to how the whole thing works.

Tom: Sure. Here is how insurance works. Suppose the value of each home in Valley View Estates is $100,000.

Alicia: That sounds about right. Go on.

Tom: Now, remember that kitchen fire last year at the Lees' home? If their home had burned to the ground, they would have lost $100,000. Follow me?

Sam: I do remember. That was awful. But how does homeowner's insurance enter into the picture?

Tom: Well, let's imagine that in a typical year, one Valley View Estates home owner loses a total of $100,000 for the one home fire. If that home is not insured, it would be a financial disaster for the home owner. That home owner would lose just about everything.

Roland: Yes, Tom, and the point?

Tom: There are 500 of us here in Valley View Estates. What if we could spread that $100,000 loss over all the rest of us? When the $100,000 loss is divided among our 500 home owners, the cost to each home owner would be only $200. ($100,000/ 500 = $200.)

Alicia: I get it. If we each paid a relatively small amount of money—say, $200 a year—we would be protected against having a big loss—possibly $100,000. We pool our money together. Maybe keep it safe in a bank. If any one of us has a fire, we are protected against the loss.

Sam: But what happens if there is no fire in one year? I guess that would be good news, but it is like we placed all that money in the pool and got nothing back.

Tom: Another good point. That is why some people—high risk takers—are tempted not to buy insurance. But if something big goes wrong—like their house burns down—they might lose everything.

Roland: Here's another problem that is much worse. What happens if we have more than one fire per year?

Tom: Excellent question, Roland. We would have to build up the money in our pool over time. Things don't always go according to plan. We would need to be prepared for unexpected costs and savings. If there were two home fires in one year, we would need to have enough cash in reserve to pay for those losses, for instance. In good years, when we have no fires, we can save the money and build up the pool.

Alicia: But we would still not be 100 percent safe, right?

Tom: Right. Nothing could make us 100 percent safe. Instead, the idea is to diversify risk, not eliminate it altogether. We could diversify risk by spreading it out over many different individuals. By doing that we could reduce individuals' losses.

Sam: Thanks for that explanation, Tom. It helps a lot. Is that how other insurance plans work?

Tom: Yes. People can buy insurance on all kinds of things in order to reduce risk. Common forms of insurance include insurance for cars, health, and life. Now, here is my plan for saving us some big bucks.

Questions for Discussion

A. Why is having home insurance important?

B. Using the example of Valley View Estates, what is diversification as applied to buying home insurance?