Risk, Return & Diversification

Accounting & Finance

Why diversification works, and what it cannot remove.

Specific risk	Systematic risk
Affects one firm or industry	Affects the whole market
Strike, recall, lost contract	Interest rates, recession, war
Diversifiable away	Cannot be diversified away
Not rewarded by the market	Rewarded with a risk premium
Largely gone by 20-30 holdings	Measured by beta

THE DIFFERENCE THAT MATTERS

Diversification is close to a free lunch: it removes specific risk at no cost in expected return.

Correlation matters more than the number of holdings. Twenty assets in one sector are barely diversified.