

2.5: Income and Risk

Learning Objectives

1. Describe how sources of income may be diversified.
2. Describe how investments in assets may be diversified.
3. Explain the use of diversification as a risk management strategy.

Personal finance is not just about getting what you want; it is also about protecting what you have. Since the way to accumulate assets is to create surplus capital by having an income larger than expenses, and since you rely on income to provide for living expenses, you also need to think about protecting your income. One way to do so is through **diversification**, or spreading the risk.

You already know not to put all your eggs in one basket, because if something happens to that basket, all the eggs are gone. If the eggs are in many baskets, on the other hand, the loss of any one basket would mean the loss of just a fraction of the eggs. The more baskets, the smaller your proportional loss would be. Then if you put many different baskets in many different places, your eggs are diversified even more effectively, because all the baskets aren't exposed to the same environmental or systematic risks.

Diversification is more often discussed in terms of investment decisions, but diversification of sources of income works the same way and makes the same kind of sense for the same reasons. If sources of income are diverse—in number and kind—and one source of income ceases to be productive, then you still have others to rely on.

If you sell your labor to only one buyer, then you are exposed to more risk than if you can generate income by selling your labor to more than one buyer. You have only so much time you can devote to working, however. Having more than one employer could be exhausting and perhaps impossible. Selling your labor to more than one buyer also means that you are still dependent on the labor market, which could suffer from an economic cycle such as a recession affecting many buyers (employers).

Mark, for example, works as a school counselor, tutors on the side, paints houses in the summers, and buys and sells sports memorabilia on the Internet. If he got laid off from his counseling job, he would lose his paycheck but still be able to create income by tutoring, painting, and trading memorabilia.

Similarly, if you sell your capital to only one buyer—invest in only one asset—then you are exposed to more risk than if you generate income by investing in a variety of assets. Diversifying investments means you are dependent on trade in the capital markets, however, which likewise could suffer from unfavorable economic conditions.

Mark has a checking account, an online money market account, and a balanced portfolio of stocks. If his stock portfolio lost value, he would still have the value in his money market account.

A better way to diversify sources of income is to sell both labor *and* capital. Then you are trading in different markets, and are not totally exposed to risks in either one. In Mark's case, if all his incomes dried up, he would still have his investments, and if all his investments lost value, he would still have his paycheck and other incomes. To diversify to that extent, you need surplus capital to trade. This brings us full circle to Adam Smith, quoted at the beginning of this chapter, who said, essentially, "It takes money to make money."

KEY TAKEAWAY

Diversifying sources of income in both the labor market and the capital markets is the best hedge against risks in any one market.

EXERCISE

Record your answers to the following questions in your personal finance journal or My Notes. How can you diversify your sources of income to spread the risk of losing income? How can you diversify your investments to spread the risk of losing return on investment?

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