What did Warren Buffett mean when he said, "Diversification is protection against ignorance. It makes little sense if you know what you are doing."

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A: Billionaire investor Warren Buffett famously stated that "diversification is protection against ignorance. It makes little sense if you know what you are doing." In Buffet's view, studying one or two industries in great depth, learning their ins and outs, and using that knowledge to profit on those industries is more lucrative than spreading a portfolio across a broad array of sectors so that gains from certain sectors offset losses from others.

The need for diversification is a portfolio theory rooted in the idea that an investor who puts all his or her money in one company or one industry is flirting with disaster if that company or industry takes a dive. A famous example from the 21st century is the Enron scandal. Many employees of the ill-fated energy company were encouraged to invest their entire portfolios in company stock; when the company fell in 2002, these employees' savings were eradicated overnight.

Especially in the wake of scandals such as Enron, diversification is widely considered a part of investing basics. Personal finance courses teach it as gospel, deriding individual stocks as tantamount to casino gambling. In fact, many investors never even invest in an individual stock. Instead, they turn to mutual funds and exchange-traded funds (ETFs), both of which bundle hundreds of stock from various companies and sell them as a singular unit.

These traders further diversify by selecting mutual funds and ETFs from different sectors that follow different trends. Some follow the ups and downs of the broader market, while others remain relatively flat. Still others move inversely with the broader market, experiencing ups when most sectors are down and vice versa. The idea behind this strategy is that no matter what the market is doing, a portion of the investor's portfolio is likely to do well.

The problem with diversification, in the view of Buffett and other like-minded investors, is that even though risk is mitigated by sector gains offsetting sector losses, the opposite is also true – sector losses offset sector gains and reduce returns.

Buffett has amassed a fortune by acquiring incalculable knowledge about all things finance and about specific companies and industries, and using that knowledge to hand-pick his investments. Few investors have been better at picking stocks and timing entry and exit points. An ignorant investor – someone with little to no financial or industry knowledge – is bound to make blunder after blunder if he or she attempts to play the market the way Buffett does.

An investor who studies trends and has a keen understanding of how different companies and industries react to various market trends profits much more by using that knowledge to his or her advantage than by passively investing across a wide range of companies and sectors. Such an investor is able to go long on a company or sector when market conditions support a price increase; similarly, the investor can exit his or her long position and go short when indicators project a fall. The investor profits in either scenario, and those profits are not offset by losses in unrelated industries.