

NOV. 23, 2009

OBSERVATIONS ON THE MARKET

No. 221

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One of the big hot buttons in finance is diversification. It is supposed to lower the risk of your portfolio. In fact, according to the theory, you are supposed to be able to increase your return while lowering your risk at the same time. Academia is now arguing whether the theory actually works, or at least to the extent all the models say it does. The last two years have proven to us that financial models do not always work the way they are designed. So just what has the last few years taught us about diversification?

Success can sometimes become your enemy. This was especially true in the 1990's when the Janus fund group had some of the hottest funds around. One mistake investors made was thinking that if they spread their money around to several of the different Janus funds, they could stay with what was a very hot group but still be diversified. The only problem was that most of Janus's funds in the late 1990's all owned the same stocks. So when the market decline of 2000 started, all of Janus's funds went down together. Another version of the same problem is when you chase performance. It is not uncommon for performance to come from a few select sectors. So even though you may own different mutual funds from completely different fund companies, they still own very similar investments. Once again the benefits of diversification are diluted. Owning individual stocks just makes the issue of diversification more complicated.

In the November 21st weekend edition of the *Wall Street Journal*, Jason Zweig discusses how many stocks it takes to diversify a portfolio in his *The Intelligent Investor* column. He suggests that it takes more than 40 different stocks, and that they must be spread out between sev-

eral different industries. His solution, since few individual investors can follow 40 plus companies effectively, is to put 90% to 95% into a total stock market index fund (a fund that buys almost all the publicly traded companies in the market place). Then, to complete the portfolio, buy three to five individual stocks. This seems to be a little overkill, since even if all five of your stocks declined to zero, you would only lose 10% of your portfolio's value.

The last year has also taught us that the financial world had become too complacent regarding risk, and that those 100-year floods seem to happen more frequently than every 100 years. Even what used to be considered boring, AA and AAA rated bonds, can become instruments of mass destruction if enough people become scared enough. Financial models don't seem to deal with scared investors very well. In the end, it seems to be a game of knowing what you feel comfortable owning, and realizing that every investment falls out of favor for awhile given enough time. Even three-month treasury bills can lose money. Last week treasury bills fell to a negative yield. Investors had to pay slightly more than \$10,000 to receive \$10,000 back when they mature. This seems odd since the credit markets are much more healthy than they were 12 months ago. This doesn't seem to be diversification, it is called losing money.

Finally, always avoid betting the farm on the sure bet. What should a ten-year old boy do when his money is earning .10% in the bank? Last year the answer seemed obvious, put it all in GE at 24 and earn a nice fat 4% dividend. After all, GE is AAA rated and how bad can it get? The answer to that question - dad is considering a stimulus package to bail him out.