Source: Smiley Pete Publishing

Finances

Don't Count Your Chickens...

Understand what influences portfolio success

by David M. Blanchett

January 04, 2008

By David M. Blanchett

COLUMNIST: FINANCE

I doubt that many Business Lexington readers are farmers, but the anecdote “don’t put all your eggs in one basket” has broader implications than just chickens and eggs. The egg quote, in its simplest form, is about diversification. Diversification from an investing perspective means holding a variety of investments with different risk and return characteristics. Diversification is an important part of any portfolio, regardless of asset size.

Harry Markowitz, one of the primer academics in portfolio theory, introduced a concept in the 1950s called Modern Portfolio Theory that still guides investment professionals today. One of the key tenants of Modern Portfolio Theory was diversification. While there are a variety of technical terms that can be used to describe the mathematical relationships that exist between investments (such as correlation coefficients or copula dependencies), diversification in its simplest form is have investments that zig when everything else is zagging, and vice versa. The less the investments in a portfolio are related, the better a portfolio will do in varying market conditions (which is something known has having a low beta).

Any investor, regardless of the amount of money he or she has available to invest, can create a balanced, diversified portfolio if he or she knows where to look. One way is to purchase individual securities, called stocks. While this is a viable approach for some people, most people do not have the time or expertise to build and monitor a prudent, diversified portfolio of individual securities (including the author, despite my technical training in security selection). This is why mutual funds, which are investments that pool the resources of a number of investors, are so popular.

Mutual funds are the most popular method of pooled investing in the United States today. Currently, there is over $5 trillion invested in over 18,000 different mutual funds in the United States. Mutual funds have an array of objectives, or goals, and give the investor the potential to obtain exposure to a variety of markets. For example, there are the basic, plain vanilla type funds that give investors exposure to big American companies (called Domestic Large Caps) and there are also mutual funds that give investors exposure to more risky and specialized investments like technology funds (anyone remember the Tech bubble of the late 90s?) as well as international equity markets, such as those for developing countries like China and India (called emerging markets).

Paul Samuelson, the first American to win the Nobel Prize in economics, once said that “investing should be dull, like watching paint dry or grass grow. If you want excitement, take $800 and go to Las Vegas.” This idea, while firmly rooted in academic theory, is in sharp contrast to the way the media portrays investing, which is anything but boring. Most of us have heard on the radio, or read about, some type of get-rich-quick marketing scheme that proclaims to have found the solution to making money in the stock market (which typically sounds too good to be true — because it is). Television shows like Mad Money, a program hosted by Jim Cramer on CNBC, make investing look exciting and easy enough for any John Doe to do. The problem with people, though, as Yogi Berra might say, is that they’re people, and people are not good investors.

A study by DALBAR, an investment consulting firm based in Boston, found that while the average annual return of the S&P 500 from 1986-2005 was 11.9 percent, the average equity mutual fund investor only returned 3.9%. Why did this happen? Because investors tend to buy things that have done well recently (a behavioral finance term known as the recency effect) without considering the possibility the best days for that investment, or that investment category, may be behind it. Prudent investing is long-term investing, not just following the "hot dot."

It is inevitable that in a diversified portfolio some funds and some asset categories are going to do better than others. In the late 90s, many people thought creating a diversified portfolio meant holding three different technology funds, versus just one. While a portfolio of three different tech funds may give the appearance of diversification, the underlying market exposures of those funds (to primarily domestic Internet start-ups) are virtually identical. Therefore, it's important to realize that purchasing different mutual funds does not itself create a diversified portfolio; a diversified portfolio is only created through mutual funds that have different underlying market (or systematic) risk exposures.

Building a prudent, diversified portfolio (i.e., not putting all your eggs in one basket) is essential to investing success. While investing and farming are different, there are similarities between the two activities. BC Forbes, the founder of Forbes Business Magazine, once said, "It is only the farmer who faithfully plants seeds in the spring, who reaps a harvest in the autumn." Or, in investing terms, "It is only the investor who prudently builds a portfolio while working, who will get to enjoy his savings during retirement."

David M. Blanchett, CFP, CFA, AIFA, works at Unified Trust Company in Lexington and can be reached at david.blanchett@unifiedtrust.com.