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Safety in Numbers—How Investors Can Increase Returns and Lower Risk

While stocks are more volatile than they used to be, i.e. a given stock is likely to be twice as risky as it was in the 1960's, the overall stock market is no more volatile now than in the 1960's. How can this be? A fascinating article in the *New York Times* by Mark Hulbert, editor of *The Hulbert Financial Digest*, cites a study done by several academics, including Burton Malkiel, a Princeton economics professor. They found that stocks, although volatile one-by-one, tend to cancel out each other's zigs and zags when viewed in aggregate. On a day when a bunch of stocks go up, most likely another bunch will go down, hence diminishing overall market volatility.

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Further, Hulbert took a look at stock investment newsletters and found that those with 10 or less stocks in a portfolio earned average annualized returns of only 1.9% over the last five years. By contrast, stock newsletters that advised holding more than 40 stocks earned a vastly higher 10.4% per year. Common knowledge has held that 10 to 20 stocks will give an investor a fully diversified portfolio. But now, given the above results, it seems to make more sense to hold at least 40 stocks in one's portfolio to get a decent return with acceptable risk. Interestingly then, not only is volatility diminished when one holds a greater number of stocks, but the return is higher! There is a definite correlation here between the number of stocks held and the rate of return.

What does this mean for investors? Is it feasible for the individual investor to hold and track 40 individual stocks to achieve the kind of return we are all looking for? In most cases, I suspect the answer would be no. Most people do not have the time, expertise or inclination to follow 40 individual stocks on a regular basis.

Mutual funds, however, may be a way one can take advantage of this phenomenon. The typical mutual fund holds anywhere from 25-100 stocks. I recommend to my clients that to be fully diversified, they should hold between 10-15 mutual funds. This means then, that in total, my clients hold 250 or more stocks, each followed by an experienced fund manager supported by a research team.

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But do Hulbert's findings in regard to stocks hold for mutual funds? He goes on to say that, in fact, they do. And, importantly, such mutual fund portfolios (touted by some investment newsletters he tracks), with many more than 40 stocks being held within the funds, were less than half as volatile as portfolios holding 11 to 20 stocks.

So the overall message is that a broadly diversified portfolio of mutual funds should serve as the centerpiece of a solid investment plan. When viewed over long periods of time, it is a prudent and wise strategy that aids your overall results, while keeping risk levels down.

How to Protect Your Company Retirement Plan Nest Egg

For most of us, our work retirement plan represents the biggest chunk of savings we have, with the possible exception of the equity in our house. And yet recent studies show that people manage their plans poorly, some taking too much risk and others not enough. In fact, since 1983, two-thirds of American households have either a) not increased their retirement savings or b) experienced drops in the value of their pensions, according to Edward N. Wolff, economist at NYU.

The subject of risks lurking in retirement plans has come to light recently with the Enron collapse. At the end of 2000, Enron's 401(k) had more than half of its assets in Enron common stock. Now many Enron employees are in shock, with their savings decimated and their ability to retire in question.

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Such problems are not limited, however, to Enron. Employees in 401(k) plans across the country have about 30% of their savings in company stock. Vanguard conducted a survey recently, concluding that investors are “myopic” about the risks of holding their own company stock in large amounts. Although investors surveyed rated individual stocks as generally more risky than stock mutual funds, they said their own company stock was less risky.

Whether that conclusion is valid depends upon which company you work for. RiskMetrics, a research company in New York, has found that Coca-Cola, Johnson & Johnson, Merck and Proctor & Gamble would not produce much greater risk in a retirement portfolio than the overall stock market. However, a worker at Microsoft holding 30% of retirement savings in the company stock and the rest in a broad-based stock index fund would be assuming about 30%

more risk than if he'd invested in the stock index alone. Similarly, a worker at Hewlett-Packard doing the same thing with her company stock would shoulder 42% more risk than the market.

So what should retirement plan investors strive to do? Granted, some companies do not make it easy to diversify, since they match employee contributions with

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company stock, but there are measures that can be taken. First of all, most experts agree that 10% of your overall portfolio, including taxable and IRA savings, should be the upper limit on holding company stock.

Start within your retirement plan to reduce exposure to the company stock. Typically you'll have at least 6 fund options, aside from a company stock fund. Change your contribution percentages to include more diversified mutual fund selections, and fewer sector or company stock funds. Then look outside your company plan, to make sure you are spreading your investments beyond your company's stock and its industry.

Finally, as the other article in this newsletter suggests, consider lowering the overall risk of your portfolio by gravitating toward diversified mutual funds in general and away from individual stocks. It's interesting to note that, since the beginning of 2000, nearly one of every five U.S. stocks has plummeted by two-thirds or more; by contrast, only about 1% of diversified mutual funds have swooned as much, according to Morningstar.

ABOUT THE ADVISOR...

Christopher Kuehne is an independent, fee-only, Certified Financial Planner (CFP) and Registered Investment Advisor. He has worked in the financial services industry for 19 years in various capacities, including 12 years on Wall Street as a Vice President at Merrill Lynch and Bankers Trust Company. Mr. Kuehne has an M.S. in Economics from Carnegie-Mellon University, is a member of the Financial Planning Association (FPA) and the National Association of Personal Financial Advisors (NAPFA).

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