Keep your eggs in different baskets

MERRICK WEALTH

By Peter Merrick

Here's a shocking story: a banker with Bear Stearns had 100 per cent of his investment assets in Bear Stearns stock.

Bear Stearns stock was selling for $171 per share in the first week of January. When a deal was initially struck for JP Morgan to buy Bear Stearns, it was for $2 per share. That is a loss of 98.8 per cent, about as close as you can come to losing it all without actually doing so. Fortunately for Bear Stearns investors, it has come up a little since then but still represents a tragic loss of capital to those who invested in the Bear.

It has only been seven years since Enron went bust and many of the 22,000 employees who 'drank the Kool-Aid' and had all their retirement money in Enron stock lost it all. Everyone knows about the Enron debacle; even people who have never bought a stock in their lives.

But did anyone learn the lesson of Enron? Not the one about avoiding cheating in the boardroom, but the one about safety in diversification or, put another popular way, not putting all your eggs in one basket. Apparently this investment banker didn't learn.

Why would someone do what is now seen as such a stupid thing? Well, if you had an investment that since 1985 had outperformed the S&P 500 Index and even beat Warren Buffet's Berkshire Hathaway, wouldn't you be tempted to depart from prudence, give in to greed, and overload in that investment? That was the story with Bear Stearns. It was a great ride up and a horrific crash, one of historic proportions.

There are less sinister reasons than the typical greed and fear cycle why someone might concentrate their holdings in one company or one sector. In Canada, public accountants have been known to frequently make the unwittingly imprudent recommendation to clients. "Just buy the banks. They always do well and pay a good dividend." That has been largely true, but is it prudent advice? Could you be taking on an unrealized liability by making that kind of narrow off-the-cuff recommendation? Investment prudence begins with an understanding of how the capital markets work.

Academic research makes it clear that financial markets around the world are essentially efficient. All public information that can be known about a stock is known by market participants and stocks are priced accordingly – the price is essentially always correct. The implication of the efficient markets theory is that it is a futile effort to try to pick stocks or time the markets in order to beat the market.

The markets are probably not perfectly efficient. However, the question for an investor is, "Is there enough inefficiency in the market so I can profit from it?" All academically sound studies have answered this question with a resounding no.

Risk and reward are related. Most people understand this at its most fundamental level; in order to have more reward, you must take more risk. In other words, risk is rewarded – but not all risk. Bear Stearns is but the latest example. Equities (stocks) are more risky than fixed income instruments (bonds). A dollar that in 1927 was invested in large U.S. stocks was worth $3,286 at the end of 2007. That same dollar invested in U.S. bonds was worth $76 at the end of 2007.

During that 80-year period, there was much more volatility with stocks than with bonds. Also, if one invested their $1 in small U.S. stocks instead of large U.S. stocks that dollar would have become $16,643 instead of $3,286. Small stocks and value stocks were more volatile than the large U.S. stocks – and they paid off with greater return.

Portfolios that are structured to provide comprehensive asset class allocation both domestically and internationally have the advantage of only taking the risk of the market, not the individual business risk of a Bear Stearns or an Enron. Consequently, the diversified portfolio is safer and will, over time, outperform. Buying the banks is a limited strategy that leaves a tremendous amount of non-systematic risk in the portfolio. When there is a difficult time for financial stocks, banks get hit, even if they aren't the bad guys. They are part of the financial sector and will be affected by the sector as a whole.

Sector investing leaves the investor with inadequate diversification. Proper diversification requires the purchasing of multiple entire asset classes – small cap stocks, large cap stocks, international developed markets stocks, emerging markets stocks. This will provide true diversification, eliminate non-systematic risk (the business risk of individual companies or sectors) and guarantee the investor the return of the capital markets. Now, that is prudent.

Of course, depending on the circumstances and purposes of the investment portfolio, some short-term fixed income assets will be appropriate to reduce the systematic risk of the stock market further.

Structure determines performance. Asset allocation explains most of the variation in portfolio returns. This means, what proportions of large or small stocks or bonds make up a portfolio. To be more specific, U.S. large value stocks, U.S. small value stocks, international value stocks, emerging market stocks, emerging market value stocks and emerging market small stocks, as well as various kinds of bond investments, can make up a portfolio

A fully diversified portfolio will have some amount of all of these asset classes in a proper recipe that maximizes return for a given level of risk. This is the essence of what is known as modern portfolio theory. A good cook will have a good recipe that won't leave the cooking to ad hoc mixing of ingredients – likewise a good investor will have an excellent investment plan that doesn't leave the choosing of investment vehicles to the vagaries of stock picking and market timing investment managers.

Charles Stanley, wealth manager in California, co-wrote this column.

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