Diversification: A good thing gone bad

“Studies have shown that more money is better than less money.”  
— Bart Wagstaff, a quick-witted Capita advisor

More is usually better; however, just as you will get sick with too much ice-cream in one sitting, so will your portfolio with too much diversification.

Diversification is good. The black line in the chart below is five well-known stocks together as one portfolio. The other colors are each of the five stocks individually. Notice how much less the black line moves up or down. This is both the benefit and the demise of diversification.

If diversification is good, how can too much be bad? At some point additional diversification becomes worthless and you are paying for it.

In the real world, we all have a risk budget. Your risk budget is how much risk or volatility we are willing to experience. Usually our risk budget is more of a feeling. For example, the value of your portfolio declines enough that you say, “I’m done!” You just found the size of your risk budget. Portfolio managers often purposefully restrict their strategy to a risk budget measured through some combination of volatility metrics. This is helpful. You are less likely to overspend your risk budget if you know in advance the risks the manager might take.

The Capita Investment Contest
Throughout the summer of 2019, Capita is holding an internal investment contest for employee training and engagement. I wanted our team members to experience the feelings involved with using a “risk budget” to construct a portfolio. It is what we expect our third-party portfolio managers to do. Risk budgeting is something you should understand as an investor.

I started with these rules:
• A maximum of five securities
• Investments must trade on the Nasdaq or New York Stock Exchange
• The portfolio standard deviation needs to be less than 16 percent (measured by five-year lookback of monthly returns)

To level the playing field between our practicing advisors and the rest of our staff, all ETFs, shorting, and leverage was excluded. There was an audible groan from the advisors with that announcement.

The contest will run through the summer months of June, July, and August of 2019. At the end, the top three winners will share $1,000 worth of prize money. Mike, our founder, threw in a $100 kicker for anyone who beats him.

This hands-on exercise has provided meaningful investment training for the staff. We are “improving lives, one
financial decision at a time,” as the mission statement of The Financial Call states, and I love it! Every team member has had to feel the difficulty of an investment fitting within a risk-managed portfolio.

Based on the name of each portfolio you’ll notice that I am having way too much fun with this.

We have four who have purposefully built a defensive strategy. If the market is down over the summer, one of them will win. Notice how three have underperformed the S&P 500 in this positive-returns environment. If we see a downturn, they might be the only ones who beat the S&P 500. The rest have tried to maximize their return using their full 16 percent standard deviation “risk budget” to do well in a positive market.

We recently ran some testing on simple index portfolios. At various levels of stocks and bonds, the portfolios showed a positive return in between 65 percent and 72 percent of months. Playing the odds and assuming a positive market is a decent bet. This why advisors may tell you to stay invested. If you had a 65 to 72 percent win rate in blackjack, your advisor would likely also tell you to stay seated at the table in Vegas. Knowing your win rate and “staying seated” in markets might just be your key to overcoming the emotional pitfalls of investing.

The employees’ portfolios which were not positioned defensively showed excess returns over the S&P 500 for the first five months of 2019. I can’t help but wonder if this strong performance could be attributed to two possible reasons.

• Hindsight investing
• Concentrated portfolios

**Hindsight Investing**
This is when you pick investments that have done well. It looks great in the rear-view mirror, but that is not a safe way to drive a vehicle forward.

A contrarian investor would rather
buy investments that have done poorly assuming a reversion to mean will cause
their portfolio to do well in the future. This
is like catching the roller coaster at the
bottom and riding it up.

A momentum investor would buy those
investments that have done well recently
assuming there is a wave to ride that will
continue to flow.

There are professional investors who
succeed at a contrarian or momentum
strategy, but rarely both in the same fund/
manager. Diversification of philosophy
is important. You may decide to include
multiply philosophies, however, don’t
expect one strategy to be both at the same
time.

Concentrated portfolios

If you ARE the market, you cannot BEAT
the market. This seems simple enough, but
you normally don’t know when you ARE
the market.

Let’s talk about cost. You may be paying
for financial planning services. The
financial planning cost is to ensure you
and your advisor make good decisions
involving categories including and beyond
investment management like taxes, estate
planning, cash flow strategies, savings
rates, and major life transitions.

Whether or not you have a planner, you
are paying for someone’s investment
knowledge or access to securities.
Investment costs are often embedded in
the investment solutions as expense ratios.
If you are so diversified that you ARE the
market, yet you are paying professionals
to try and BEAT the market, you are paying
for active management without a chance at
active returns.

Take a stance. Either BE the market or
attempt to BEAT the market, but don’t pay
a fund to BEAT the market and then end up
BEING the market.

MarketWatch has a list of the top 25
mutual funds by assets under management.
There are only two actively managed funds
on the list, the rest are index funds. Active
funds typically transact more often and
charge a higher fee for management called
an expense ratio. Expense ratios are only
a portion of the cost of investing in funds.
Listen to The Financial Call podcast episode
with Kurt Brown on Model Delivery for
more information about this.

Let’s look at these two actively managed
funds that are listed in the top 25 in terms
of assets under management. One of these
funds has 299 positions and one has 296
positions. Many funds are pushing 500+ positions so nearly 300 is relatively low.
The S&P 500 has 505 names in it. If you
own just a couple funds, how different are
you from the index? There is a term for
this scenario: “closet indexing.” You pay an
expense ratio of 0.5 percent to 1.5 percent
for what you could have gotten in an index
fund for 0.05 percent. The other option
is to buy the underlying stocks directly
with no expense ratio. This involves a lot
less turnover and trading which is more
efficient.

I audited a portfolio recently that had
over 500 mutual funds. If the average fund
has 300 to 400 positions — which is low
— that portfolio has 150,000 to 200,000
lines to the underlying positions in those
funds. The account was less than $500,000.
This is less than $4 invested per underlying
position. For relative reference, the New
York Stock Exchange only trades roughly
3,000 stocks.

Diminishing diversification benefit

You’ve heard that diversification is good,
for example, at the beginning of this article
when I said, “Diversification is good.” In the
early stages of portfolio construction, the
diversification benefit is massive. However,
it diminishes quicker than you realize.

To teach risk budgeting, my team needed
some measurement to assess risk. There
are many sophisticated ways of doing
this — Beta, Treynor, Sharpe, downside
capture — however, to keep it basic, we
chose standard deviation (SD). SD is just a
measurement of variation. It answers the
question: How much will the returns of this
portfolio vary?

Standard deviation can feel like a magician
pulling sleight-of-hand tricks on your mind.

I purposefully chose five well known
stocks that have an incredibly tight range of
SD. The average is 17.8 percent. The range
is 17.7 percent to 17.9 percent.
One would think, “If the average variation in each stock’s returns is 17.8 percent, then the average variation in my portfolio must also be 17.8 percent.”

The magician hands are waving … it’s 11.9 percent.

Since these five stocks (although very similar in the amount of variation) move up and down based on different factors, the variation of the group as a whole is less than the parts.

Perfect, we proved that diversification is good, just like ice cream, but when do you get sick?

The next chart shows the SD as you add each stock to this portfolio. The average SD is blue, the actual SD is orange. Look at how much the SD dropped upon adding the second stock! Now compare that with adding stock No. 5. The SD decrease by adding the fifth stock is barely noticeable.

Admittedly, we have selected five stocks from a similar category, however, most people have hundreds of stocks in each category. Adding Stock No. 5 reduced SD from 12.2 percent to 11.9 percent, a difference of 0.3 percent. How much benefit are you really getting with stock number 3,951 in your funds? Instead of “Let’s properly diversify your portfolio,” I would like to say to my clients, “Let’s properly concentrate your portfolio.” It is a strange concept, but hyper-diversification has become the emperor’s new clothes.

My team’s personalities are beaming through their stock selection in the Capita contest. They learned that you can take five highly volatile stocks and get the portfolio down to 16 percent standard deviation. They also learned they need to beat Mike to earn $100. Luckily, Mike built one of the four defensive strategies which is completely opposite to his personality. Most of us will walk away with a cold Benjamin if we can count on that 70 percent of months being positive.
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