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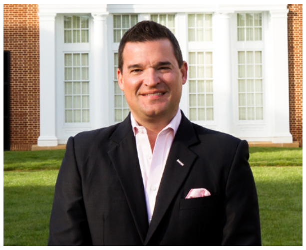
VAGUE DESTINATION

coddiwomple

verb | cod•di•womple | \kä-də-wäm-pəl

: to travel in a purposeful manner towards a vague destination



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Despite the fact that economies and financial markets constantly march towards Vague Destinations, a successful investor must remain purposeful, which means being data-dependent, process driven and risk conscious.

This week **in "The Key to Good Performance," we coddiwomple through the misused and misunderstood concept of "diversification…"**

Focus and concentration are the keys to accomplishing anything of significance and experiencing success in any area of life. Yet when it comes to investing, concentration seems to be a four-letter word.

Instead, diversification gets all the glory as **the** way to invest, and as the primary tool for sound risk management.

Like a game of telephone that started in the '70s, the definition of "diversification" has been somewhat butchered. "Diversification" has come to mean that the more investments you have in your portfolio, the better.

But is that really diversification?

The true concept of diversification is having a portfolio of uncorrelated holdings. In layman's terms, it means having holdings that zig and zag for different reasons and at different times.

Let's dig into the reality of "diversification" and see where the real risk lies. I can promise you that a half-assed attempt at diversification exposes your hard-earned capital to many more risks than a properly constructed concentrated portfolio.

Forbes 400 Says What?

Who are the richest people in the U.S.? Look at the most recent Forbes list of the 400 richest people. Specifically, look at the top ten. How did they acquire such vast wealth?

No. 1 Bill Gates: one stock, Microsoft; No. 2 Jeff Bezos: one stock, Amazon; No. 3 Warren Buffett: one stock, Berkshire Hathaway; No. 4 Mark Zuckerberg: one stock, Facebook; No. 5 Larry Ellison: one stock, Oracle; No. 6 Michael Bloomberg: one company, Bloomberg L.P.; Nos. 7 and 8 the Koch Brothers: one company, Koch Industries; Nos. 9 and 10 Larry Page and Sergey Brin: one stock, Google.

So, the top ten richest people in America accumulated their vast wealth through CONCENTRATION, not diversification. Most people blindly ignore this fact of success because diversification is treated as the Holy Grail of risk management. It also serves as the cornerstone of most financial advisors' investment plans for their clients.

Correlation vs. Diversification

I'm currently helping someone evaluate the proposal of a financial advisor for an inheritance she recently received. The advisor recommended a portfolio of twelve different mutual funds; three were bond funds and the remaining nine were various equity funds.

The equity funds covered the following Morningstar fund categories: large cap, global real estate and world allocation.

However, when I evaluated each fund, I discovered something interesting. Each of these nine funds, including the global real estate and world allocation funds, had at least 70% of their assets invested in U.S. companies. Furthermore, at least 83% of those investments were in large cap companies. To put this in perspective, large cap companies, defined by a market cap greater than $10B, represent just 10% of all U.S. listed companies.

Needless to say, it didn't surprise me when I ran a correlation analysis on these funds and determined that they were highly correlated to each other. This means that the funds tend to rise and fall together in price. They may have different names and belong to different categories, but they all zig and zag in unison in response to the performance of U.S. large cap stocks.

This over-concentration on large caps is why I was not surprised to find a nearly perfect correlation between each of these funds and the SPDR S&P 500 ETF Trust (SPY). In statistical terms, all nine funds essentially move lock-step, in both directions, with the S&P 500.

The fixed income funds paint a similar picture. The correlation between these three funds was also strongly positive. The three bond funds were also positively correlated to the iShares Barclays Aggregate Bond ETF (AGG). This exchange-traded fund is made up entirely of U.S. fixed income. Even the one proposed bond fund that was categorized as a "global bond fund" tends to move lock-step, up and down, with AGG.

How's that for a lack of diversification—and all thanks to a misguided attempt to diversify!

You (Sometimes Don't) Get What You Pay For

The fees on the proposed equity mutual funds range from 0.41% to 0.97%. That sounds pretty reasonable for actively managed funds, until you factor in that these are institutional shares. These mutual funds were going to be purchased through a wrap account that charges an additional 1.5% per year of assets under management.

That brings the total cost up to a minimum of 1.9% (or maximum of 2.5%) per year for funds with the exact price movement of the S&P 500 exchange-traded fund SPY, which charges 0.09% per year.

Similarly, the expense of the proposed bond funds significantly exceeded the 0.05% annual fee for simply investing in AGG.

Bottom Line

The advisor's plan is to spread the inheritance out over twelve mutual funds and charge roughly 2% per year, when a portfolio with nearly identical statistics (beta and standard deviation, not to mention a better 1, 3 and 5-year performance track record) could have been constructed by putting 70% of the inheritance in SPY and the remaining 30% in AGG, for a blended cost of only 7.8 basis points per year.

So, a concentrated portfolio of just two ETFs offers the same risks as a portfolio of twelve mutual funds. The concentrated portfolio also has the additional benefits of better performance and a 96% discount in annual fees.

Your Homework

Evaluate your own portfolio to see if you, or your advisor(s), are guilty of diversifying for diversification's sake.

In my experience, there are very few circumstances where more is more.

I can understand that it might **feel** better to have twelve funds instead of two. It might **feel** like your portfolio is safer the more your money is spread.

But when has **feeling** ever improved investment performance?

The underlying reality is often like the advisor's proposal: nine different mutual funds all relying on the performance of just one segment of the U.S. equity market, which in this case is large cap U.S. equities.

Make sure that each of your holdings has a purpose and, ideally, each position is beholden to only one economic or financial market catalyst.

Remember what film and television actress Betty Buckley said: "Good performance is about the capacity to focus and concentrate." Well said, Betty, well said.

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