

Basket Case

Despite endless reminders from the experts, investors are still not diversifying their portfolios

BY MOSHE A. MILEVSKY

WOULDN'T BE SURPRISED IF THE WORD

"diversification" has appeared in more personal-finance articles than "portfolio" or "investments." Diversification to a financial planner is the equivalent of location to a real estate broker; both capture the essence of their trades and both have become clichés. Financial planners, consultants and academics have been preaching the virtues of "not putting all your eggs in one basket" ever since, well, there have been eggs and baskets.

Yet a comprehensive study by Yale University's William Goetzmann and Cornell University's Alok Kumar that tracked the behaviour of investors over a five-year period, raises serious doubts as to whether anybody is actually listening to this seemingly tiresome advice. The scholars studied a database of more than 40,000 investment accounts totalling close to US\$2.5 billion in assets from a large U.S. discount brokerage covering the years 1991 to 1996. They measured the extent to which investors diversify their stock holdings and construct "efficient" portfolios that balance risk and return across different industries and economic sectors.

Their results are revealing. First, while the average portfolio had almost US\$36,000 invested, the median number of stocks it held

was only three. Yes, three. In the most recent sample year, more than 25% of the portfolios contained only one stock, and more than 70% contained five or fewer. Even worse, these stocks tended to be clustered in the same industry, so portfolios were not diversified or well-balanced. The most popular were IBM, AT&T, Wal-Mart, Merck and Glaxo, which is consistent with the heavy trading volume in these stocks.

The authors tracked the evolution and performance of the brokerage accounts, and as the table shows, investors become more diversified over time. By 1996, more than 30% of the accounts had more than five stocks, while in 1991 the number was closer to 17%. But this is a far cry from the 20 to 30 names that most experts believe are needed for a properly constructed portfolio.

Investment returns in the study consistently lagged the major indices and tended to be more volatile. This means that the average stock in the average portfolio fluctuated more in price than the average stock in the index. Even worse, individual securities have tended to get more volatile during the last 10 years. Thus, old rules of thumb dictating the size of a diversified portfolio must be revised upwards as well. If individual stocks are bouncing around more, you must buy more of them to smooth out the bouncing.

Now granted, some might argue that because this data is based on discount brokerage accounts, it reflects "play money" and not

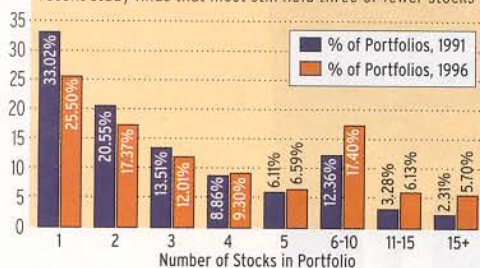
people's beloved nest eggs. But this doesn't appear to be the case. The researchers were careful to document that the average portfolio size was quite large compared to the average annual income of the owners of the portfolios. The average account represented at least 100% of annual income, so this was not casino money we're talking about.

Also, while the numbers are more than five years old (academic studies are notoriously slow to be published) the recent technology boom and bust only serve to confirm the author's conclusion that people are practising inappropriate and naive stock selection.

So if the U.S. experience is any indication — and I would argue that our investor behaviour is similar — while you may be tired of hearing about the importance of spreading your assets across various sectors, most people are still not listening. So, here it is one more time. Take a close look at your financial portfolio and make sure that your assets — and especially your stocks — are diversified. **E**



ALL OR NOTHING Investors are diversifying more, but a recent study finds that most still hold three or fewer stocks



Source: W. Goetzmann and A. Kumar, "Equity Portfolio Diversification," NBER Paper #8686