Diversification -- Too Much of a Good Thing *(Continued)*

The goal of investing is to make you money. To do this, you can either take the time and make the effort to learn how to do it yourself or hire someone to do it for you. If you had a perfect crystal ball, you would select the one best investment and put all your money into it. Nearly all great fortunes are the result of concentration, usually one person founding a company and focusing on one idea. But this is an all or nothing strategy and no one has a perfect crystal ball. If you pick the wrong person or the wrong idea, you can lose your investment. Warren Buffett (the most successful investor of our generation) operates one step removed from this. He has suggested that people would do better if they limited themselves to twenty investment selections in their lifetime. But he has also said that he wouldn't care if they closed the stock exchange for two years, and that he's willing to hold through price declines of 30%. Most investors are unwilling to take that 30% risk or to ignore the prices of their investments for two years. They lack the confidence to choose the one right idea or the one right stock or the one right time. So, for our clients, we diversify into 20 or more securities. We spend a lot of time and mental effort working to understand the securities available and the climate we live in. We put what we learn on paper because, frankly, the better you understand what we are doing, the easier it is for us to make money for you.

When I was studying engineering, we were taught to include a "safety factor" in all of our designs. In many cases, the safety factor was 100%. One day, when discussing safety factors, our professor commented that a safety factor is really an ignorance factor. We used the safety factor to compensate for our ignorance of the material, the construction, the maintenance and, of course, our design. Similarly, in investing, we diversify to compensate for our ignorance.

No matter how much work we do in getting to know a company, an industry or an economy, we will still have a 20-30% chance of being wrong. No matter how well we get to know the people involved, there are some things they won't tell us. Often because they don't (or can't) know, but sometimes because they won't admit it. And a certain small percentage will lie to us. So we check the statistic books and find that most of this risk can be neutralized (diversified away) by owning 15-20 securities. So we plan to own 20 or more securities.

Based on some knowledge of basket/security construction:

We avoid commodities and futures because they are a zero sum game and both the users and producers work to drive prices down. We are very skeptical of options and other derivatives because they are also a zero sum game and time works against you. We avoid limited partnerships because the fees are too high. We know that CD's are guaranteed to lose you money after taxes and inflation (except for a brief period of time in the early 80's.) We are skeptical of debt instruments - bonds, mortgages, fixed annuities - because we know they are managed for the benefit of the issuers, and against the interests of the investor.

Based on some knowledge of the current investment climate (on which we have written extensively -- call for a copy):

We are avoiding real estate and electric utilities. We are very skeptical of foreign investing because the dollar is undervalued. We are willing to own bonds at a price. We are not willing to confine ourselves to narrow categories of investments. When you check the history of the people who have good long-term records in investing, you will find that they are generalists. Warren Buffett concentrates his assets but he chooses from a broad list of possibilities. So does (did) John Templeton, Peter Lynch, John Neff, etc. If you read what they've said or written, each has strong convictions about how to choose investments and/or egg baskets. Each one has a consistent philosophy of investing and a documented track record of results. We would be comfortable to have any one of these people manage all of our money.

But the recent, self-promoted fad in the investment advisory business is to have a journalist, a stockbroker, or a financial planner pick a broad array of investment specialists "for diversity." They will tell you to own or hire a specialist in paper baskets, a specialist in cloth baskets, a specialist in metal baskets, a specialist in plastic baskets, etc. in order to have "diversity" as if that were your goal. They even document the success of each specialist in his field. But they don't show you their own past record at picking the specialists. Their selections are all hindsight. They imply that perfect hindsight equates to a perfect foresight but that's not often the case.

So, what should you do? Keep a diary of your thoughts on investing and the articles which make sense to you. Over time, you will learn what works and what doesn't. But you can shorten the learning curve by using your local library. The next time you are in the library, get the 1/31/94 issue of Forbes magazine. On pages 132-133, Mark Hulbert lists the performance since 1983 of a number of investment letter writers. Make a copy of the article and take it home. When you get a solicitation in the mail from a letter writer, check their track record.

When you read an article in a current magazine that seems to make a lot of sense, go to the library and see what the author or the magazine recommended 3-5 years ago. Use the same method for checking Morningstar's reviews on mutual funds.

Checking the record of you stockbroker or financial planner is likely to be more difficult. Most don't keep or publish a record of their recommendations or their results. Talking to a number of satisfied clients may be the best that you can do.

Finally, try to get differing opinions on each general topic. It will broaden your perspective and help you make an informed decision. You may have noticed that our opinions tend to differ from many others -- not only on diversification but also on risk, income vs. principal, and the current investment climate. If you would like to review our thoughts on any of these topics or to discuss them, please give us a call.