BUSINESS

ARBOR OUTLOOK

Investing in your best 90 ideas

Margaret McDowell

Author's Note: This is the second in a two-part series on mutual funds.

"Too many people going underground ... Too many reaching for a piece of cake;
Too many people pulled and pushed around ... Too many waiting for that lucky break." — from "Too Many People," as recorded by Paul McCartney

Mutual funds are so titled because the assets inside the funds are "mutually owned" by a group of investors. Shareholders gain or lose proportionally with the fund's performance. Some investors choose this vehicle as a way of having a "one-stop" diversified, managed portfolio in an asset class like US stocks. And so mutual funds may represent an appropriate investment vehicle for some, depending on factors like the investor's age, financial goals and risk tolerance.

Seasoned investors may want to consider two questions, though, regarding investing in mutual funds: "How many good ideas can one fund manager have at the same time?" and "How many securities do I need in my portfolio to provide diversification?"

Great ideas are rare. It's certainly possible to have 10 or 20 solid investment ideas simultaneously, particularly in bear markets when bargains are popping up frequently. But having 100 brilliant ideas at one time is probably a stretch. Simply understanding and tracking the machinations of 100 large companies is a significant challenge.

Actively managed stock mutual funds hold hundreds of stocks, so we can probably assume that some of those ideas will be better than others. So it may be more effective to put more dollars into your top ten or 20 ideas and less into your 250th best idea.

At this point you might be saying to yourself, "Owning that many stocks surely protects me from downturns by providing massive diversification." Surprisingly, this is actually not the case. Diversification benefits decline precipitously, from a statistical standpoint, after one acquires 20 to 30 securities in different industries. At this number of securities, you take away much of the "one-off" idiosyncratic risks that concentrated portfolios feature. But basically, beyond this number of stocks, you're likely just adding holdings and not increasing diversification.

There's a difference between adding true diversification to a portfolio and proving illusory diversification, or "di-worseification." Imagine that you own 10 rental houses. You should be thoroughly diversified in rental housing, right? If those houses are all different sizes, prices, and in different locations all over the country, then you're probably pretty well diversified. But if your 10 houses are all cookie-cutter replicas on the same street, you're probably not diversified. If the neighborhood goes downhill, even owning 100 houses won't help.

One of my favorite investment sayings is "There's nothing worse than being right and still not making money." Investing is hard work, so when you do your homework you at least want to get meaningfully compensated when you've invested wisely.

Margaret R. McDowell, ChFC, AIF, author of the syndicated economic column "Arbor Outlook," is the founder of Arbor Wealth Management, LLC, (850-608-6121 — www.arborwealth.net), a "fee-only" registered investment advisory firm located near Sandestin.