

For Fiduciaries: Diversifying Risk vs. Stock-Picking

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Both the Uniform Prudent Investor Act and the Prudent Investor Rule place great emphasis on three factors to achieve investment success: broad diversification of risk, low costs, and low taxes. While it is easy to see how lower costs and lower taxes both help increase return, not many investors understand that broad diversification of risk can also enhance return. In fact, an investor using broad diversification of risk has a better chance of building wealth than one who tries to pick stocks or time the market. There are three simple rules governing the arithmetic of investment gain or loss.

Rule Number 1: Any given percentage loss hurts a portfolio more dollar-wise than a percentage gain of the same magnitude.

For example, say you have \$100 dollars in your portfolio. You experience a 50% gain then a 50% loss. Most people would say that you broke even, but this is not the case. The 50% gain increased your portfolio to \$150, while the 50% loss then reduced it to \$75. You have actually incurred a \$25 loss.

Rule Number 2: A percentage gain must always be larger than the percentage loss preceding it to get back to a portfolio's original dollar value.

Review the above example again. You had a 50% loss to your portfolio, leaving you with \$50 dollars in your portfolio. However, a 50% gain will only bring you up to \$75. You would actually need a gain of 100% to get back to your original value of \$100.

Now, let's examine the following table. Which portfolio is better?

Table 1

Year	Portfolio 1 Annual Return %	Portfolio 2 Annual Return %
1998	8.04	28.58
1999	10.50	21.03
2000	1.32	-9.09
2001	0.62	-11.88
2002	-6.33	-22.10
2003	27.56	28.69
2004	13.97	10.87
2005	7.77	4.90

At first glance, Portfolio 2 appears to be the better choice, having three years where the return exceeded 20%. Portfolio 1 pales in comparison, with only one year where the gain topped 20% and four years of single-digit returns, as opposed to Portfolio 2 which had only one.

Now let's look at the same table again but with cumulative returns added:

Table 2

Year	Portfolio 1 Return %		Portfolio 2 Return %	
	Annual	Cumulative	Annual	Cumulative
1998	8.04	8.04	28.58	28.58
1999	10.50	19.38	21.03	55.62
2000	1.32	20.95	-9.09	41.48
2001	0.62	21.70	-11.88	24.67
2002	-6.33	13.99	-22.10	-2.88
2003	27.56	45.40	28.69	24.98
2004	13.97	65.71	10.87	38.57
2005	7.77	78.59	4.90	45.37
Return (simple avg)		7.93		6.38
Return (compound)		7.52		4.79
Risk (std deviation)		9.32		15.90

As you can see, a closer look at these two portfolios shows the real winner. Portfolio 1 had a cumulative return of 78.59% while Portfolio 2 ended up with 45.37%. Also, Portfolio 1 had better average returns (both simple and compound) than Portfolio 2. Furthermore, when you look at risk (standard deviation), you find that Portfolio 1 is much less volatile than Portfolio 2.

This is the third rule regarding the arithmetic of investment success: The greater the volatility of a portfolio the more that volatility “snuffs out” compound return.

“Volatility” refers to the constantly changing values of investments held in a portfolio. Volatility (also called risk) is measured using standard deviation. The reduction of a portfolio’s volatility not only reduces loss but, as shown in Table 2, it can also enhance gain.

Why is Portfolio 1 less volatile? Because it has a broadly diversified allocation of 60% stock asset class funds and 40% fixed income asset class funds. Portfolio 2, on the other hand, is simply composed of the stocks that make up the Standard & Poor’s 500 Index. This shows how broad diversification of risk not only reduces volatility, but can also help increase the return on your portfolio.