Fiduciary Focus: Active vs. Passive Investing (Part 3)

W. Scott Simon | 04-07-05 |

This month's column continues the multipart series I began two months ago that explores active investing and passive investing within the context of modern prudent fiduciary investing.

Most Risk Can Be Diversified by Holding a Few Stocks

As I have noted a number of times, the 1994 Uniform Prudent Investor Act and the 1992 Restatement 3rd of Trusts (Prudent Investor Rule) place great emphasis on the duty to diversify. This is nothing new, though, since a basic provision of the 1974 Employee Retirement Income Security Act requires fiduciaries of corporate employee retirement plans such as 401(k) plans to discharge their duties "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."

It is often claimed that most risk of the overall stock market can be diversified away by holding, say, 40 or 30, or even just 10 stocks. For example, a booklet published by the American College of Trust and Estate Counsel, a group of the most elite estate-planning attorneys in the United States, states: "Empirical studies have shown that a small amount of diversification goes a long way. For example, it has been shown that a portfolio of 10 stocks provides 88.5% of the possible advantages of diversification. A portfolio of 20 stocks provides 94.2% of the advantages of diversification."

Other studies tell much the same story. For example, holding two stocks instead of one stock reduces uncompensated risk by 42% in a randomly selected portfolio. Holding six stocks instead of one stock reduces uncompensated risk by 71%, and holding 20 stocks instead of one stock reduces uncompensated risk by 81%.

Restatement Commentary also picks up on the claim that most risk of the overall stock market can be diversified away by holding relatively few stocks: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries and having other differences in their qualities."

While this widely accepted claim is accurate, there is much more to the story. A surprisingly little-noticed four-page academic article published 30 years ago by a professor of finance who co-founded the Center for Research in Security Prices at the University of Chicago tells fiduciary and non-fiduciary investors the rest of that story.

In his article, Professor James Lorie observes that in any given year the expected return of a 50-stock portfolio isn't the same as the expected return of the overall stock market. The expected return of that portfolio will instead be within a potentially large range of returns falling around the market's return. For example, if the annual market return is 10% there's a significant chance statistically that the portfolio's return will fairly often differ as much as 4.5 percentage points above or below that return. In his example, a 50-stock portfolio could, therefore, return as little as 5.5% or as much as 15.5% in any given year.

Diversification of Uncompensated Risk

Restatement Commentary notes that the duty to diversify risk is based on principles of Modern Portfolio Theory. One central principle is that total portfolio risk is comprised of two kinds of risk: compensated risk and uncompensated risk.

Uncompensated risk, which comprises about 70% of total portfolio risk, reflects how the market price of a particular stock is impacted uniquely by economic and non-economic news. For example, the price of Microsoft stock may go down as a result of the departure of a key Microsoft executive.

Uncompensated risk is avoidable by an investor that invests in the stock market. An investor holding only Microsoft stock can protect itself against this risk by also owning stock in companies that are unaffected by the departure of Microsoft executives.

Restatement Commentary further notes: "The ultimate goal of diversification would be to [completely eliminate uncompensated risk and thus] achieve a portfolio with only the [compensated] … element of risk." Commentary to Section 3 of the Act adds: "The object of diversification is to minimize [the] uncompensated risk of having too few investments."

A fiduciary, then, ordinarily has the duty to diversify the uncompensated risk in a portfolio. Restatement Commentary describes the penalty for not doing this: "Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill." These three duties comprise the very meaning of "prudence."

Because the range of potential returns on either side of the overall stock market's return can vary substantially from year to year, a portfolio of even 50 "carefully" selected stocks in Prof. Lorie's example fails to achieve the potential of fully reducing the portfolio's uncompensated risk. Even the expected return of a portfolio containing as many as 200 stocks can deviate one percentage point on either side of the stock market's expected return.

Other academics cite similar data: Diversification of a randomly selected portfolio shows that a 20-stock portfolio has 21% more risk than a portfolio holding 100 stocks, and a 100-stock portfolio still has 5% more risk than a portfolio of 1,000 stocks. The diversification effect of a non-randomly selected portfolio is even greater.

Although the one percentage point differential on either side of the market's expected return in Prof. Lorie's example or the 5% additional risk that exists in a 100-stock portfolio as compared to a 1,000 stock portfolio may not seem like much, when the dollars represented by such percentages are negatively compounded over long periods of time they can result in enormous differences in accumulated wealth.

A Little Means a Lot

So while it's accurate to say that a substantial amount of risk can be diversified away in portfolios that hold, say, 10 to 50 stocks, fiduciaries should understand the potential consequences when not all (or nearly all) risk is eliminated.

That "not all (or nearly all)" is what active money managers (even--and maybe particularly--those even at the largest, most prestigious money management institutions that typically hold portfolios of only 20 to 40 stocks for high-net-worth clients) "leave on the table" as seemingly small amounts of uncompensated risk. Uncompensated risk for which investors receive no return (that's why it's called "uncompensated") can also lead to less return--sometimes a lot less.

It's crucial for fiduciary investors (as well as non-fiduciary ones) to understand that in this context "a little means a lot." Underperforming the market by even one percentage point on an average annual basis can, over time, result in large amounts of dollars left on the table. The flipside of this, of course, is the enormous wealth added to the table by Sir John Templeton and John Neff, who each outperformed the market by two to three percentage points on an average annual basis over more than 30 years.

Those investing for themselves can freely hold portfolios with whatever amounts of uncompensated risk they desire. Some of these investors, rather than underperforming the market by, say, two percentage points on an annualized basis, may outperform it by that much.

Those investing for others--fiduciaries--generally do not have such luxuries. Fiduciaries are required by principles of modern prudent investing to consciously assess portfolio risk. That ordinarily includes minimizing uncompensated risk to avoid leaving large amounts of dollars on the table. The most efficient and effective way to avoid that risk is to invest in a passively managed portfolio.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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