

# When Doing Nothing Presents the Greatest Investment Risk of All

The scenario: You hold \$10 million of a single growth stock. This holding constitutes a significant portion of your net worth. You're considering contributing a portion, say \$2 million, to an exchange fund because it provides instant diversification with no immediate tax liability and very attractive wealth transfer benefits. But, you wonder, is now the right time? Your hesitation probably takes one of two forms:

## **My stock is flying high**

and there is no way I will forego the upside that it potentially offers by trading it in for a portfolio of securities that may not perform as well.

- or -

## **My stock has been hit badly**

but I know it will come back. Its bright future just hasn't been recognized yet and when it is, there will be tremendous upside. There is no way I'm making a move now.

What's the right course of action? What "bet" are you willing to make? Perhaps asking yourself these questions will help: Would you risk your \$10 million concentrated stock position on the flip of a coin? Would you gamble it all on one hand in a game of blackjack? If your answers to these questions are no, then you should seriously consider that exchange fund. The passive act of "standing pat" with your concentrated stock position poses a potential higher risk of a disappointing outcome than placing an active bet would provide. In this case, the smart bet is on diversification. Why? *Because it works.* Here's how.

Let's say your stock is a **high flyer**. Our studies over a 10-year period (1990-99) show that an investment in a single growth security will underperform a diversified basket of growth stocks approximately 75% of the time. If you have been in the exclusive 25% of the population whose stocks have outperformed the index over that time, then you have bucked the odds. But you can't count on always coming out a winner. There are various events that can occur outside of an investor's control that might have an adverse impact on the financial future and performance of your stock going forward.

The most recent turbulence in the market illustrates this point well. On average the ten largest stocks in the NASDAQ 100 Index as of the end of 1999 have underperformed the Index significantly through September 30, 2000 (-16.2% for the top ten vs. -4.0% for the NASDAQ) and technology bellwethers like Intel and Microsoft are off more than 50% from their highs.

It is a common behavioral and cognitive error to project most recent trends into the future. Good performance leads to overconfidence. While it might be impossible to believe that your nicely performing stock could face some turbulence, based on our studies, the odds suggest 3:1 that this is the most realistic outcome.

But what if you're one of those whose stock has been **badly hit**? Even though your stock has been a dismal performer lately, you are certain that the market as a whole has misjudged its future. You want to be around to participate fully in the recovery of the stock before you turn it over to a diversified portfolio of securities that you suspect will underperform your single stock.

Implicit in this assumption once again is the basic cognitive error that we make in our investing decisions. The same evidence offered above that diversification works applies here as well. Hard evidence is often useful in aiding us with our everyday common life decisions, and we typically learn from past mistakes. Again, our studies show that only one in four stocks outperform an index or a diversified basket of securities. However, the common cognitive error of loss aversion makes it extremely difficult for an investor to part with a stock in which he or she has lost money. This plague, called "get-evenitis", hits us all and can be extremely detrimental to our financial future.

Simply put, diversification is the act of not putting all your eggs in one basket, but rather spreading them out. Investing even a portion of your concentrated stock holding in an exchange fund achieves two the main goals of prudent investing: It allows you to achieve your return objectives while controlling the riskiness of an investment.

Investors often find themselves in an emotional bind where they try to achieve the impossible with their investments: Investing for the long term by being caught up in the short term. Transferring a portion of a concentrated stock holding to an exchange fund actually allows the investor to place two bets on the table, another type of diversification. Exchanging a portion of the stock for a diversified portfolio of securities exchanges the performance of the concentrated stock for the performance of a portfolio of stocks. And keeping a portion of assets as concentrated stock assures you future participation in the stock's outperformance, if that should happen. Hedging your bets is the key to investment success.

Irrespective of whether the stock you are considering placing in an exchange fund is currently beating or trailing the averages, the evidence clearly suggests that you increase the chances of a favorable outcome the moment you diversify that holding. Our studies show that out of a randomly selected sample of 1000 single-security portfolios held over a three-year period (1997-99), 16% posted negative returns! On the other hand, out of 1000 randomly generated 25 stock portfolios tested, none ever posted a negative return over the same time period.

A diversified portfolio provides lower volatility and higher consistency of return over the long term. The end result is that while you might have given up the 25% chance of beating the index by doing nothing, you greatly improved your chance of gaining participation into a more stable and consistent investment by making the decision to diversify.

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