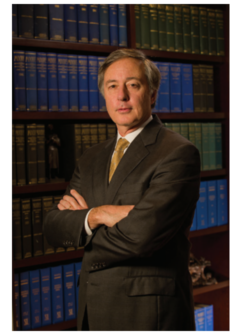
EVERYTHING IN MODERATION, DEARIE: AVOIDING THE PITFALLS OF OVER DIVERSIFICATION



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Too much of a good thing can be wonderful

Famed Hollywood starlet Mae West once said "Too much of a good thing can be wonderful." While admittedly a high class problem, it's a function of a bull market as well. And while Ms. West has a valid point, it is one that can potentially wreak havoc in your portfolio.

Suppose you bought 1,000 shares of the hypothetical company "Widget International" and, due to overwhelming demand for their newest model, the stock price quintupled. It now represents 10% of your portfolio, which seems a bit top-heavy. Fortunately, you bought it over a year ago so you will be subjected to less onerous capital gains tax. And it may appreciate a bit more—and wouldn't that be a good thing? Well, yes and no. While the idea behind investing typically is for our money to appreciate, too much of a good thing can in fact be troublesome. By holding an undue amount of Widget International, you may be precluding your ability to buy another (hopefully) undervalued stock.

An Age-Old Problem

In many cases, two stocks may be too few and 100 stocks may be too many. So where's the middle ground? Often, it can be found via smart diversification.

In their book, *Investment Analysis and Portfolio Management*, Frank Reilly and Keith Brown reported "… about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks… Academia has focused on the risk of not being diversified enough, we believe that there's a practical risk to being too diversified."[1]

Often, the end result of over diversification may be mediocre returns. Many portfolio managers are, in truth, closet indexers. They sometimes resist straying too far from the herd for fear of losing more assets if they are wrong than they can gain if they are right.

Consider A New Strategy

When seeking to maximize returns, it may be worth exploring a different strategy. Rather than trying to get in on every deal you see, you may want to try focusing on the stocks you know well—if you admit you're human, that is normally about 20 stocks. Trying to keep track of many more names than that would likely be cumbersome and could diminish the effect should a particular stock outperform. To put this concept into simple terms, say you have 20 stocks in your portfolio that you bought for the same price. If one doubles in price while the rest remain constant, your portfolio has gained 5%. Meanwhile, if you had 80 stocks in the same scenario, your portfolio would only increase by 1.25%. But keep in mind there is a flipside, and conversely, a portfolio with fewer stocks can have a larger negative effect from stocks that perform poorly than a larger portfolio. Either way, the fewer stocks you have, the bigger the shockwave.

While a child might say you can never have too much candy, and a woman may say you can never have too many diamonds, the same is not necessarily true for stocks. By sticking to names you know and keeping your portfolio size manageable, you may be able to avoid the pitfalls of over diversification and enjoy just the right amount of a good thing.

[1]Frank Reilly and Keith Brown, Investment Analysis and Portfolio Management
(South-Western Cengage Learning , 2012)

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