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LESS IS LESS: THE DIFFICULTY WITH OWNING INDIVIDUAL EQUITIES

A NUMBERS GAME

There's nothing wrong with owning individual stocks. There are countless high-quality, well-managed, consistently growing Canadian and international companies that if traded properly can result in excellent long-term portfolio returns. However, individual stock ownership comes with drawbacks and our concern is two-fold:

1. *A large number of stocks are required to properly control risk and achieve global diversification and the transaction costs associated with holding and trading this many equity positions can be high.*

2. *There is a low likelihood that any investor or portfolio manager can adequately monitor all the resulting positions and make informed and consistently accurate buy and sell decisions. There are also additional costs associated with properly monitoring and managing so many equity holdings.*

Stocks are fine if you can afford the cost of diversification or if you can handle the heightened risk of a concentrated portfolio, but for the reasons we detail below, we argue that it's generally more efficient to realize your equity exposure through broadly diversified, low-cost exchange trade funds (ETFs).

ONE OR MORE OF YOUR STOCK PICKS WILL PROBABLY FAIL—BIG TIME

It's an inescapable capital market reality that individual stocks frequently suffer catastrophic losses. Even apparently safe, well-established companies find ways to self-destruct, which can devastate improperly diversified portfolios. JP Morgan examined the price action for securities in the Russell 3000 Index, a broad-based index of US equities, and showed that, over time, the odds of any one position experiencing a catastrophic loss—a decline of 70% or more from the peak with minimal recovery—were 40% and in some riskier sectors, such as information technology, the odds rose to nearly 60% (see table below).

If you held a portfolio of only, say, 10 stocks, imagine how devastating it would be to have even just two or three of these positions plunge 70% at the same time? In other words, picking losers is costly in small portfolios and would likely force you to significantly rethink your financial goals, or worse, delay your retirement plans. Incidentally, your risk is amplified even more if you own stock in the company you work for because anything that threatens a company's share price likely threatens your job as well.

Falling From Grace

Sector	Total % of companies experiencing a "catastrophic loss", 1980–2014
Consumer Discretionary	43%
Consumer Staples	26%
Energy	47%
Materials	34%
Industrials	35%
Health Care	42%
Financials	25%
Information Technology	57%
Telecommunication Services	51%
Utilities	13%
All sectors	**40%**

Source: JP Morgan; a catastrophic loss is defined as a 70% decline from peak value with minimal recovery. Data based on Russell 3000 Index constituents.

While the JP Morgan data is focused on US companies, stock blow-ups are also a familiar feature of the Canadian market. See if you can recognize these notable Canadian stock market disasters: A) Company executives blatantly lie about a massive Indonesian gold deposit and the company goes bankrupt; B) The CEO of a telecom giant is fired with cause, but cashes out with $130 mln; shortly after the company completely implodes; C) A once-great smartphone maker runs into the iPhone buzz-saw and the company's share price collapses more than 90% from its highs; D) An iconic aircraft manufacturer places a massive wager on a new jet design that fails to impress the market; the company will now require a provincial government bailout; E) A company's paper-based directory business gets annihilated by Internet and mobile phone competition; F) A research report accuses a pharmaceutical powerhouse of "Enron-like" accounting and its share price plummets. Answers: A) Bre-X, B) Nortel, C) BlackBerry (Research In Motion), D) Bombardier, E) Yellow Pages, and F) Valeant Pharmaceuticals.

As an ETF investor you need to pay attention to such things as macro-economic data and valuations—just as you would with individual stocks—however, with ETFs, company-specific risk, which is involved in all of the examples above, means little. As an ETF holder do you care if a particular CEO absconds with company funds, grabs a private jet and heads to the Cayman Islands? Not at all. ETFs with their broad diversification neutralize this risk.

These examples, of course, raise a corollary question: can market analysts adequately monitor all relevant data and news flow to fully understand each company's risk factors and share-price drivers? Possibly, but it becomes much less likely across 60 or more individual stocks (see "Eight is NOT Enough" below). The forces that could move share prices across so many positions become impossible to anticipate unless you have enormous resources, but resources cost money, which is why mutual funds and other money managers charge so much for their services—and even then their success rate is dubious. Proper management becomes even more difficult when global equities are included as this requires an even broader informational skill-set that few advisors possess. We'll be the first to admit, for instance, that we couldn't pick an individual Japanese or Brazilian equity to save our lives.

In the end, simply having a carefully considered broad-market or regional-market outlook ("We're bullish on European equities for these reasons...") and expressing this view through a diversified ETF becomes the most practical, cost-effective and manageable investment strategy. The alternative is to attempt to frequently trade dozens of volatile individual stocks based on difficult-to-forecast (and monitor) company-specific factors.

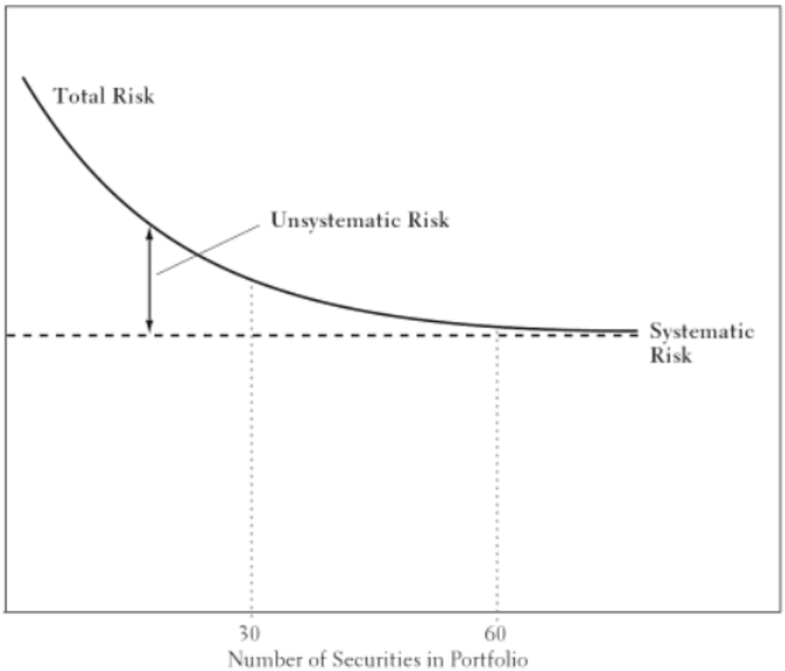
EIGHT IS NOT ENOUGH

Because stocks have this tendency to frequently collapse, you need a lot of them to properly control risk. In short, you need to increase your odds that you will end up owning a stock that will skyrocket in value in order to offset the inevitable landmines. So what's the right number of positions? While the research varies, it is generally agreed that 40 stocks would be the *minimum* required to achieve adequate risk control. One influential paper written by researchers Vitali Alexeev and Francis Tapon concludes the following:

We recommend that professional portfolio managers who use standard deviation as a measure of risk, and who seek to reduce 90% of diversifiable risk 90% percent of the time…should hold 49 stocks in the US; 43 in the UK; 39 in Japan; 40 in Canada; and 38 in Australia.

You can see the difficulty. To have risk-controlled exposure to the US market takes dozens and dozens of individual stocks. To create a true global portfolio likely takes dozens more. Burton Malkiel in his classic book, *A Random Walk Down Wall Street*, shows visually what is required to completely eliminate "unsystematic risk" in a US portfolio. *Systematic* risk refers to market risk. For example, the 2008–2009 financial crisis more or less indiscriminately dragged down all stocks. *Unsystematic* risk refers only to company-specific risk. For example, Enron went bankrupt because management was fraudulent. Systematic risk cannot be eliminated through diversification, but unsystematic risk can be. However, as you can see from the chart below, eliminating unsystematic risk in Malkiel's example takes about 60 individual securities. Keep in mind that eliminating unsystematic risk doesn't mean that you're risk-free, it simply means that you've brought risk down to a level that doesn't exceed the market. Equities, even in large numbers, will still be riskier and more volatile than most other asset classes.

PROPER DIVERSIFICATION: IT TAKES A LOT



Source: Burton G. Malkiel, A Random Walk Down Wall Street

While the exact number of securities needed to control risk is debatable, the real problem is that individual investors typically are nowhere near even the low end of estimates. In fact, seldom does their equity tally even reach double-digits. Researchers William N. Goetzmann and Alok Kumar in their widely studied paper "Equity Portfolio Diversification", which examined the trading activity of some 40,000 US discount brokerage accounts over six years in the 1990s, showed that do-it-yourselfers were extremely poor portfolio managers:

The observed degree of under-diversification among investor portfolios in our sample is quite surprising. More than 25% of investor portfolios contain only 1 stock and more than 50% of them contain fewer than 3 stocks… An average investor holds a 4-stock portfolio (median is 3) [and] less than 5% of them hold more than 10 stocks….

Think of the incredible risk being taken with a four-stock portfolio given what we now know about the JP Morgan study? We certainly see new clients come to us all the time with similarly high-risk, under-diversified portfolios. However, the task of creating a properly diversified global stock portfolio is not an inexpensive one. Owning dozens of individual domestic and international stocks, which is what is required to properly control risk, isn't cheap. Owning, for example, 60 positions that have to be traded frequently will quickly rack up transaction costs. It is not uncommon to pay $100 or more per trade with a commission-based advisor and a 100% yearly turnover (not unusual in volatile markets) equates to potentially $12,000 in trading costs: a massive 4.8% annual expense on a $250,000 portfolio, for example. Adding an option strategy could simplify this process and result in fewer trades, but this adds more complexity and risk. You could perhaps trade the stocks yourself at a reasonable cost at a discount brokerage, but you probably wouldn't be reading this if you thought that you had the time and energy to perform such complex due diligence on your own. A fee-based advisor could give you an all-stock portfolio at a reasonable cost, but even then you could not be assured of the advisor's international equity expertise. It's likely that, at the very least, your global equity exposure would be achieved via a high-priced mutual fund or some other expensive external money manager. **In the end, the most practical way to build a true global equity portfolio at a reasonable cost is with a fee-based advisor who uses ETFs.** To achieve the same risk and cost control as an ETF by using individual stocks would require a portfolio in the millions of dollars.

EQUITY EXPOSURE: STICK TO ETFS

If you pick stocks, no matter how talented you are, you will almost certainly eventually end up with a holding that suffers a catastrophic loss. Therefore, to reduce concentration risk and mitigate such disasters, a diversified global portfolio of at least 60 stocks is appropriate. Owning, monitoring and trading this many individual positions is not cheap and not practical for most investors. We believe that the most effective way to get equity exposure is through ETFs, particularly when global diversification is desired. Buying only a handful of individual stocks is like buying a lottery ticket: you might win, but you probably won't. But unlike a losing lottery ticket, a losing under-diversified stock portfolio could delay your financial goals for years. With individual stocks, less is less. Fully diversified, low-cost equity ETFs are a much better way to go.

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