ADVICE FOR THE **FUTURE**

OUTSIDE EDGE

BY

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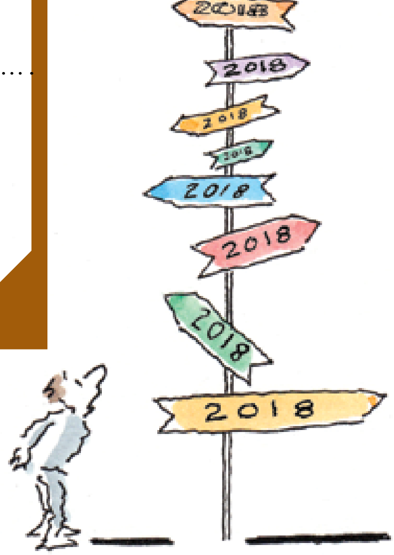

NOT-SO-FINE DINING

The push to diversify has gone awry.

If diversification is the only "free lunch" investors have, then what is over-diversification? A sub-par meal at an expensive restaurant?

Our industry has gone way too far with the diversification mantra. We have run steadily and without constraint to a point where clients today own hundreds, and in many cases thousands, of stocks in their portfolios.

There were many people involved in getting us to this state of affairs.

At the product level, too many mutual funds and structured products have bloated portfolios, owning hundreds of securities. In the minds of the designers (marketing departments and investment bankers) and money managers, there is a perceived need to stay close to the index and have exposure to all types of stocks and geographic areas.

At the dealer level, advisors build portfolios with a variety of funds and other products (some of them bloated in their own right) such that the security count is multiplied many times over.

As for the clients, they may use multiple providers, including one or more of the following: account executive; bank branch advisor; discount broker; and neighbour's counselling firm. In too many cases, nobody involved has a grasp of the full picture, including the client.

As a new player in the wealth management industry, our team has had an opportunity to meet refugees from all parts of the business. What we're finding—crowded, high-cost portfolios that do a fine job of replicating the indexes—is good for business. It's easy to come up with something that's more focused and cohesive.

So what kind of meal should we be serving our clients? Should they own 25, 50, 100 or 1,000 securities?

On this topic, the research is all over the map, and not particularly helpful. But, with regard to equity-only portfolios, most studies show that after 20 to 25 stocks, the diversification benefit becomes negligible. In other words, adding a 26th stock does little to dampen down short-term volatility.

While a portfolio of 20 stocks and a few government bonds were just fine for our parents a generation ago, it's probably not enough today. But for a portfolio that is pursuing higher returns through active management, the number of securities should be closer to that end of the spectrum as opposed to the other end where the indexers reside.

To move our clients into the appropriate diversification envelope, we don't need to read an academic paper or do a statistical analysis. Common sense will work just fine. Clients need diversification across asset classes and a mix of company types, countries and currencies. Holding managed products with significant overlap in their holdings can easily be avoided. (How many places does your client need to own Potash Corp. or Encana?). And a risk-management system isn't required to make sure that the portfolio isn't hinging on one theme or bet—like the never-ending growth of Chindia, or $200-a-barrel oil.

If the clients' overall portfolio looks like an index fund, then the fee should reflect that. On the other hand, if they are paying a premium fee for experience and expertise, they should have a portfolio that's focused on fewer securities.

Like a fine restaurant, the menu is limited and the entrées are delicious. AE

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