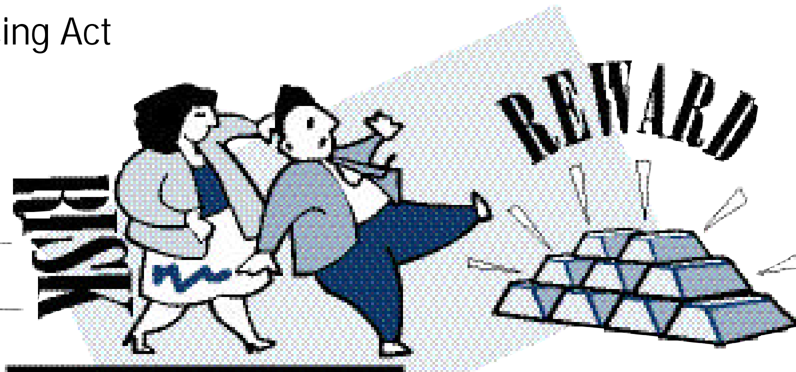
Balancing Act



Fixed income holdings help dampen the risk of your overall portfolio – to serve as your "safety net" when investment times are tough. But purchasing equity (stock) holdings is equally vital to the long-term well-being of your investments. After all, a safety net is supposed to allow you to take a bit more risk.

Of course rewards that you can expect from equity investing are not without their risks.

1. The stock market is inherently riskier than fixed income investing.
2. Various stock asset classes carry different levels of risks — large-cap is less risky than small-cap, and growth ("glamour") is less risky than value (distressed).
3. Each company's stock holds some risk. As we saw recently with Enron, even investing in a company that appears rock solid bears some risk.

In addition to holding fixed income, another way to control your portfolio's risk is by **diversifying** your equity holdings. Effective diversification can reduce the volatility of your portfolio without reducing expected returns. The risk of individual stock ownership can be diversified away in a low-cost, tax-efficient manner by owning passive asset class, index or exchange traded funds that basically own all the stocks in the asset class/index. The risks of individual asset classes can be managed by building a globally diversified portfolio and allocating funds across all the asset classes.

Given the benefits of diversification, how many investors actually take full advantage of it? A study by William N. Goetzmann and Alok Kumar, "Equity Portfolio Diversification," concluded the number was disturbingly low. After examining more than 40,000 equity investment accounts at a large discount brokerage firm, 1991–1996, they found that the vast majority of investors held portfolios that were clearly undiversified, holding an average of just four stocks. Even investors with larger numbers of stocks tended to hold almost all the same kind (typically large-cap growth), thus benefiting very little from diversification.[1]

Several studies have revealed impediments on which investors stumble, failing to achieve adequate diversification:

- We mistakenly believe that holding numerous stocks ensures diversification even if the stocks are highly correlated (similar). While holding several stocks helps dampen the risk of individual holdings, it does not address the risk of concentrating too much wealth in particular asset classes.
- We are overconfident of our or our broker's stock-picking skills, assuming we are in the rare minority who can successfully identify "winning" stocks.
- We believe that we can better manage our portfolios by limiting how many stocks we hold. If we are familiar with a company, we argue, it must be a safer investment, leading us to concentrate our holdings in too few companies.

Evidence that so many investors succumb to such fallacies is particularly distressing, as a changing equity market has rendered diversification increasingly important. In December 1968, a paper published in the *Journal of Finance* concluded that an investor should doubt "the economic justification of increasing portfolio sizes beyond 10 or so securities."[2] By 2000, a newer study found that "even 60-stock portfolios achieve less than 90% of full diversification."[3] Yet another recent study argues that a dramatic increase in the volatility of individual stocks and a declining correlation of stocks within the S&P 500 Index has led to a significant increase in the number of securities needed to achieve the same level of portfolio risk.[4]

Despite the benefits of diversification, investors appear to have an increasingly difficult time constructing well-diversified portfolios. Explanations range from our own psyche to increasing challenges inherent in the market. Nevertheless, we are optimistic that investors can still achieve their objectives in today's market. Our helping hand can never hurt.

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1 Yale ICF Working Paper No. 00-59, October 2001.
2 *Journal of Finance*, December 1968.
3 *Journal of Investing*, Winter 2000.
4 *Bloomberg Wealth Manager*, July/August 2000.

The Best and Brightest College Tuition Plans

In our Spring 2000 *Educated Investor* newsletter, we analyzed state college tuition plans that fall under the Federal tax regulations of Section 529 of the Internal Revenue code — "529 plans." At that time, we concluded that some may be of value under some circumstances. But we also recommended that readers carefully consider their other choices — such as the traditional "custodial account" or simply mental accounting of education funds within your own account.

Today, as improvements have been made, we believe 529 plans may prove to be a valid choice for many who are considering the best way to develop a college savings plan. Almost every state now has or is in the process of introducing its own 529 plan. This is good news for you, because you are not required to place your savings in your own state's plan. Thus, for example, as a New Jersey resident, you could use a Missouri state plan for your child to attend college in Oregon.

529 Characteristics

Each state forms an alliance with a specific investment provider to offer its plan. For example, Missouri and New York use TIAA/CREF, but Iowa and Utah are allied with The Vanguard Group. Thus some states' programs are better than others at enabling adherence to the passively managed investment approach we recommend. Each state decides what investment selections will be available, typically comprised of mutual funds with prescribed balances of equity versus fixed income. Asset allocations are generally based on the age of the child, with the allocations becoming more conservative over time. But several states now offer 100 percent equity options. We've seen annual fees ranging between 0.65-1.8 percent. It pays to shop around.

Contributors and Beneficiaries

The account is in your name for the benefit of the child. While most accounts are established by parents for the benefit of their children, any individual can establish a state plan for any beneficiary who is planning for qualified higher education. An account can later be rolled from the benefit of one child to the benefit of another member of that child's family.

Use of Proceeds

529 plan investments should *only* be used to pay for qualified higher educational expenses (but not limited to tuition) at any eligible college. Penalties and taxes are applied if funds are withdrawn and not used appropriately.

Investment Tax Implications

Contributions to a 529 plan are considered by the IRS to be a completed gift, removing the assets from your estate. Some states allow additional tax benefits if you invest in your own state's plan. You can roll over your 529 plan tax- and penalty-free among different state plans as often as once every 12 months to take advantage of more attractive options that may become available.

Withdrawal Tax Implications

When it comes to withdrawals, there is some good news. Effective in 2002, withdrawals are now free from federal tax. The catch is that this law is only in effect until 2010. If Congress declines to extend the law, withdrawals beyond 2010 will be taxed at the child's ordinary tax rate as it had been previously.

Weighing Your Options

To attract investments, states are competing against each other to offer the best plan. What may be the best choice today may not remain so into the future. Thus it is useful to include your 529 plans as part of your managed assets to ensure our up-front and ongoing assistance. Our advice to you will be unique based on your overall investment objectives, where you live (whether state tax benefits are or become available), your children's ages, investment options that are or become available, how large a role financial aid is likely to play, tax considerations and many other factors.

Are 529 Plans Right for You?

In our Spring 2000 article on college tuition plans, we compared 529 plans with custodial accounts as well as with savings within your own account. At that time, we concluded that some 529 plans had the potential to yield marginally better results, but that most of them faced serious hurdles, such as limited investment flexibility, conservative allocations and a negative impact on financial aid.

We are more optimistic today. As states compete against each other for investor dollars and as new options emerge, we are hopeful that the advantages available from many current 529 plans will more frequently outweigh the disadvantages. At the same time, with continual changes taking place at the state as well as at the federal level, ongoing consultation with us will be of more value than ever helping you select the best initial plan, and helping you change to new plans when it is in your best interest to do so.