# THE RISKS OF CONCENTRATING YOUR WEALTH IN ONE INVESTMENT

### THE PROBLEM:

Many investors concentrate their wealth in a small of number companies - often including the one they work for.

### WHAT IT MEANS FOR YOU:

A large holding in a single company offers a possibility of tremendous gains, but a much higher likelihood of catastrophic loss.

### THE SOLUTION:

Investors have a much greater likelihood of success if they hold a diversified portfolio with no single-company risk.

If you had bought 5,000 shares of Apple back in March of 2005, it would have cost you about $200,000. Seven years later, those shares would be worth over $3 million. Meanwhile, an investor with a globally diversified equity portfolio would have been fortunate to earn 3% or 4% annually over the same period.

> *Single stock portfolios bear huge amounts of risk*

Some people draw a simplistic conclusion from anecdotes like this: by concentrating your investments in one (or perhaps two or three) companies, you give yourself an opportunity to become extremely wealthy. This is true as far as it goes: certainly a diversified portfolio can never be expected to increase by a factor of 15 in seven years like Apple did. Unfortunately, the tiny possibility of a 15-bagger comes with a much greater likelihood of catastrophe. As financial author William Bernstein points out, "In investing, it is all too often true that the same things that maximize your chances of getting rich also maximize your chances of getting poor."

### WHY DO INVESTORS HOLD SO FEW STOCKS?

Behavioural economists have begun to ask why investors concentrate their portfolios in the first place. One theory is related to the way people think about investing. Rather than trying to understand how financial markets work in the broadest sense, they tend to believe that investing is about analyzing the unique characteristics of individual holdings. But this kind of thinking is fraught with problems.

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When investors focus on trying to understand individual companies, they quickly become anxious, even overwhelmed. With thousands of stocks to choose from, they cannot hope to analyze all of them, so they default to the companies most familiar to them. For many people—whether they are executives who actually make the decisions, or line workers and receptionists with stock-purchase plans—the company most familiar to them is the one they work for.

*The company most familiar to many investors is the one they work for*

The problem is that this familiarity bias makes investors believe that because they understand the inner workings of their own company, it is somehow less risky. But this is an illusion. Anyone who believes they have any control over their company's share price should ask Jim Balsillie and Mike Lazaridis of Research in Motion just how dangerous this illusion can be.

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## What this means for your retirement plan

In a paper called "The Concentration Crisis," analyst David Loeper set out to quantify the risk of concentrating a portfolio in a single stock. He used the example of Harry, a 55-year-old investor. Harry has a $1-million portfolio and plans to draw an income from the investments beginning at age 65. He also wants to leave a $1-million estate for his heirs.

Loeper ran thousands of Monte Carlo simulations to find the probability that Harry would achieve these goals in different scenarios. He started with a diversified portfolio and then ran more simulations assuming that Harry held 40%, 80% and 100% of his assets in a single stock. (Loeper used Cisco, but one could easily substitute Apple, or Research in Motion, or an energy or mining stock.) Under these different scenarios, Harry's probability of success or failure varied dramatically:

TABLE: IS CONCENTRATION RISK REWARDED? (1,000 SIMULATIONS EACH)

| CONCENTRATION RISK (percentage allocated to a single stock) | SUCCESS (Harry met or exceeded his target at time of death) | UNDER TARGET (target missed, but assets greater than zero) | FAILURE (Harry ran out of money before his death) |
|---|---|---|---|
| 0% | 80% | 7% | 13% |
| 40% | 59% | 12% | 30% |
| 80% | 38% | 11% | 51% |
| 100% | 21% | 11% | 68% |

As the above table reveals, a diversified portfolio allowed Harry to reach his goals 80% of the time, and he ran out of money in only 13% of the simulations. However, with a concentrated portfolio, he was playing with fire. Even with 40% of his assets in a single stock, his probability of success fell to just 59%. By concentrating all of his wealth in an individual company, Harry ran out of money in two-thirds of the simulations. True, he could have bought Apple and become extremely wealthy—but the most probable outcome was that he would have died broke.

*A portfolio that is free of single-stock risk dramatically reduces an investor's chance of catastrophe*

There are no sure things in investing, and diversification does not guarantee success. However, a portfolio that is free of single-stock risk dramatically reduces an investor's chance of catastrophe. "It's bad enough that you have to take market risk," writes William Bernstein. "Only a fool takes on the additional risk of doing more damage by failing to diversify properly with his or her nest egg."

This paper was co-written by the members of the Final Frontier Group (FFG). Founded in 2006, the FFG is an independent study group comprised of six successful portfolio managers and financial advisors affiliated with various firms across Canada. The mandate of the Final Frontier Group is to facilitate the sharing of unbiased "best practice" ideas and portfolio research.

The common thread uniting members of the group is a keen interest in the science of investing and the desire to excel at client service. The advisors in the FFG collectively oversee more than $1 billion worth of private client assets.

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