

# How Many Stocks Should You Own?

The answer is a lot more, and a lot fewer, than you probably think



**With the market near record** highs and doing some violent bouncing, you may be thinking it's time to focus on a small number of stocks that you know really well. What better way to keep returns up and risk down?

Conventional wisdom and new academic research certainly seem to suggest this is the way to go. Many financial planners and brokers will tell you that a portfolio of as few as 12 stocks (and up to 30) will sufficiently diversify your holdings. And three recent studies have found that individuals who own fewer stocks do better than those who own many.

However, as is often the case with conventional wisdom (and academic research), there's a lot more to the story. Fact is, if you build your portfolio entirely on the principle of "less is more," you're a lot more likely to end up with less than more. Here's why and what to do instead.

## THOSE WERE THE DAYS

The idea that 12 to 30 stocks are all you need dates back at least to the 1960s, when academics—including Burton Malkiel, author of the classic *A Random*

*Walk Down Wall Street*—concluded that that's what it took to eliminate most of the risk from a portfolio. (They usually defined "risk" as the chance of suffering big swings away from the average market return.) But back in the days of hula hoops and transistor radios—and before computer-generated trading became common—stocks didn't bounce around the way they do today. In 2001, Malkiel found that it took 50 stocks to get the risk reduction that 20 used to provide. Others estimate that true diversification requires hundreds of stocks.

## THE FOCUS FACTOR

Just recently, however, researchers studying the performance of individual investors have discovered something that, at first glance, seems electrifying: The more concentrated a portfolio is, the higher the returns. One study found that investors whose portfolios were dominated by one or two stocks outperformed the most diversified stock owners by 0.8 to 4.8 percentage points annually on average. That's a huge gap. And roughly 8% of the top performers had portfolios

concentrated in a single stock. So the heck with diversification, right?

Well, not exactly. First, the least-diversified investors frequently lagged the market; they just lagged by less than investors who held more stocks.

Second, because stock returns are so uneven, the "average" undiversified investor doesn't really exist. At any given point, there are something like 10,000 stocks in the U.S. Most of them are mediocre, but a handful are what Bill Bernstein of Efficient Frontier Advisers dubs "superstocks" capable of delivering gargantuan returns for years. Think Microsoft in the '90s, when it returned 9,000%. (More often superstocks are lesser-known companies.) Across a large group of people whose portfolios are mostly in one or two stocks, the lucky few with superstock portfolios will make the group's average return look great, even if the vast majority of individual members have lousy or middling results.

On the other hand, investors who spread their bets across dozens of stocks have only a slightly better chance at catching a superstock. And if they do land one, it won't have nearly as much impact on their portfolios, or on the group's average return.

So the real story is that you need a lot of stocks to be adequately diversified, and you need a concentrated portfolio to give yourself a shot at striking it rich. An unsolvable catch-22? Hardly. In fact, you can have it both ways by employing a

## HAVE YOUR CAKE...

To keep your portfolio adequately diversified and give yourself a shot at the big score:

Invest **90%** of your money in an index fund **+** Put **10%** into your one to three favorite stocks

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SPECIAL INSTRUCTIONS

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# the intelligent investor

straightforward, two-part strategy.

First, direct 90% of your U.S. equity allocation into a total stock market index fund that automatically gives you a stake in thousands of companies. That guarantees you a piece of every superstock that already exists or might emerge later—

and, more important, it means you'll be adequately diversified and your investing costs will be at rock bottom. Then pursue your search for the next Microsoft or Google by researching the daylights out of a very small number of companies and putting the remaining 10% of your

portfolio into your one to three best ideas. This way you'll let yourself have a little fun. You will also minimize your risk and maximize your hope. **\$**

*Jason Zweig is the author of the forthcoming Your Money and Your Brain. E-mail him at investor@money.com.*

## Money70

OUR LIST OF RECOMMENDED MUTUAL FUNDS AND ETFs

Emerging markets funds were the stars of an otherwise difficult month for MONEY 70 equity funds. **SSgA Emerging Markets** posted the best performance, returning 2.9% for the four weeks ended July 27. Bond funds fared well. **American Century International Bond** led the way with a 2.6% gain. Real estate funds—and REIT funds in particular—were hard hit. The **Vanguard REIT Index** fund and **REIT ETF** were down 8.7%.

FUND (TICKER)	TOTAL RETURN			EXPENSES (AS % OF ASSETS) <sup>2</sup>	PHONE NUMBER (800)	FUND (TICKER)	TOTAL RETURN			EXPENSES (AS % OF ASSETS) <sup>2</sup>	PHONE NUMBER (800)					
	1 MO.	1 YR.	3 YRS. <sup>1</sup>				1 MO.	1 YR.	3 YRS. <sup>1</sup>							
<b>Large-Cap</b>						<b>Specialty continued</b>										
American Funds Amcap (AMCPX) <sup>3</sup>	-1.6%	16.9%	10.7%	0.64	421-0180	iPath Dow Jones-AIG Comm. (DJP)	1.42%	3.11%	N.A.	0.75	764-7284 <sup>8</sup>					
Am. Funds Am. Mutual (AMRMX) <sup>3</sup>	-2.8	16.0	11.6	0.55	421-0180	iShares Dow Jones Select Div. (DVP)	-5.9%	6.9%	10.6%	0.40	474-2737					
Fidelity Dividend Growth (FDGFX)	-3.3	15.7	10.2	0.59	343-3548	iShares Goldman Sachs Nat. Res. (IGE)	-0.6	20.3	28.3	0.50	474-2737					
Fidelity Spartan 500 Index (FSMIX)	-2.9	16.2	11.8	0.09	343-3548	Third Ave. Real Estate Value (TAREX)	-6.6	10.5	18.7	1.11	443-1021					
Fidelity Spartan Total Mkt. (FSTMX)	-3.3	16.5	12.9	0.10	343-3548	T. Rowe Price New Era (PRNEX)	-1.7	25.3	29.1	0.67	638-5660					
iShares S&P 500 Index (IVV)	-2.8	16.2	11.8	0.09	474-2737	Vanguard REIT ETF (VNQ)	-8.7	-1.9	N.A.	0.11	851-4999					
Jensen (JENSX)	-2.0	13.8	7.1	0.85	992-4144	Vanguard REIT Index (VGSIX)	-8.7	-1.9	17.0	0.21	851-4999					
Madison Mosaic Investors (MINVX)	-3.0	11.5	7.3	0.95	368-3195	<b>Foreign</b>										
Matrix Advisors Value (MAVFX)	-4.3	25.1	11.0	0.99	366-6223	Am. Funds Euro Pacific Gr. (AEPGX) <sup>3</sup>	-2.1	22.9	23.9	0.75	421-0180					
Selected American (SLASX)	-4.3	13.2	13.0	0.90	243-1575	Artisan International (ARTIX)	-3.2	21.6	22.5	1.20	344-1770					
Sound Shore (SSHFX)	-2.8	17.3	13.4	0.92	551-1980	Dodge & Cox Intl. Stock (DODFX)	-3.1	22.7	25.9	0.66	621-3979					
T. Rowe Price B/C Growth (TRBCX)	-1.6	20.5	11.6	0.82	638-5660	Fidelity Spartan Intl. (FSIIX)	-3.7	21.0	22.1	0.09 <sup>7</sup>	343-3548					
T. Rowe Price Equity Income (PRFEX)	-4.0	15.9	13.1	0.69	638-5660	iShares MSCI EAFE Index Fund (EFA)	-3.1	21.7	22.1	0.35	474-2737					
Vanguard 500 Index (VFINX)	-2.8	16.1	11.7	0.18	851-4999	Oakmark International (OAKIX)	-4.2	18.2	21.9	1.09	625-6275					
Vanguard Total Stock Mkt. (VTSMX)	-3.2	16.5	12.8	0.18	851-4999	SSgA Emerging Markets (SSEMXX)	2.9	46.6	42.8	1.25	997-7327					
Vanguard Tot. Stk. Mkt. ETF (VTI)	-3.2	16.5	12.9	0.07	851-4999	T. Rowe Price Emer. Markets (PRMSX)	0.9	48.2	41.8	1.25	638-5660					
Vanguard Windsor II (VWNFX)	-4.6	15.9	14.4	0.34	851-4999	T. Rowe Price Intl. Discovery (PRIDX)	-1.5	34.5	30.0	1.24	638-5660					
<b>Midcap</b>						Vanguard Em. Mkts. ETF (VWO)	2.1	44.5	N.A.	0.29	851-4999					
Aston Mid Cap (CHITX)	-3.3	30.7	15.4	1.16	992-8151	Vanguard Em. Mkts. Stock (VEIEX)	2.1	44.4	39.1	0.41	851-4999					
FAM Value (FAMVX)	-4.9	14.1	9.6	1.18	932-3271	Vanguard Intl. Growth (VWIGX)	-3.6	22.1	22.9	0.54	851-4999					
Fidelity Value (FDVLX)	-4.4	19.2	17.5	0.67	343-3548	Vanguard Total Intl. Stock (VGTIX)	-2.8	24.0	24.2	0.32	851-4999					
FPA Perennial (FPPFX) <sup>4</sup>	-3.5	16.5	12.0	0.92	982-4372	<b>Bond</b>										
Janus Mid Cap Value (JMCVX)	-3.9	17.7	15.0	0.93	525-3713	American Century Intl. Bond (BEGBX)	2.6	6.0	5.4	0.82	345-2021					
Meridian Growth (MERDX)	-3.4	17.4	11.9	0.85	446-6662	American Funds Amer. H/I (AHITX) <sup>5</sup>	-3.7	7.0	7.7	0.65	421-0180					
Primecap Odyssey Agg. Gr. (POAGX)	-2.5	22.0	N.A.	0.99	729-2307	Dodge & Cox Income (DODIX)	-0.1	5.4	3.9	0.44	621-3979					
Vanguard Mid-Cap ETF (VO)	-4.2	18.7	18.0	0.12	851-4999	FPA New Income (FPNIX) <sup>6</sup>	0.7	5.1	3.3	0.62	982-4372					
Vanguard Mid-Cap Index (VIMSX)	-4.2	18.6	18.0	0.22	851-4999	Harbor Bond (HABDX)	1.2	4.6	3.9	0.58	422-1050					
<b>Multicap</b>						iShares Lehman 1-3 Yr. Treas. (SHY)	0.9	5.2	3.0	0.15	474-2737					
Bridgeway Agg. Inv. 2 (BRAIX)	-1.7	22.5	21.8	1.13	661-3550	iShares Lehman TIPS Bond (TIP)	1.9	4.0	3.9	0.20	474-2737					
Muhlenkamp (MUHLX)	-6.6	6.4	9.9	1.04	860-3863	iShares Lehman U.S. Agg. Bd. (AGG)	0.8	5.3	3.7	0.20	474-2737					
Weitz Hickory (WEHIX)	-7.3	15.1	11.5	1.20	304-9745	Vanguard Infl.-Pro. Sec. (VIPSX)	1.9	4.1	4.0	0.20	851-4999					
<b>Small-Cap</b>						Vanguard Interm.-Term T/E (VWITX)	0.5	3.9	3.4	0.16	851-4999					
Neuberger Berman Fasciano (NBSFX)	-5.6	13.4	7.5	1.20	877-9700	Vanguard Short-Term Bond (VBISX)	0.8	5.5	3.2	0.18	851-4999					
Royce Opportunity (RYPNX)	-5.3	20.3	16.2	1.11	221-4268	Vanguard Total Bond Mkt. (VBMFX)	0.8	5.5	3.8	0.20	851-4999					
Royce Pennsylvania Mutual (PENNX)	-5.1	16.6	16.2	0.87	221-4268	<b>Target-Retirement</b>										
T. Rowe Price New Horizons (PRNHX)	-3.0	16.8	14.6	0.83	638-5660	T. Rowe Price Retirement (STOCK/BOND ALLOCATION)										
Vanguard Small-Cap ETF (VB)	-5.6	15.6	15.0	0.09	851-4999	2005 Fund (55%/45%) (TRRFXX)	-1.5	12.5	10.2	0.61	638-5660					
Vanguard Small-Cap Index (NAESX)	-5.6	15.5	14.9	0.23	851-4999	2020 Fund (80%/20%) (TRRBX)	-2.7	16.3	13.0	0.72						
<b>Specialty</b>						Vanguard Target Retirement										
Cohen & Steers Realty (CSRSX)	-8.4	-2.1	19.5	0.96	330-7348	2025 Fund (81%/19%) (VTTVX)	-2.3	15.5	10.9	0.21	851-4999					
						2035 Fund (90%/10%) (VTTIX)	-2.8	16.7	12.6	0.21						

NOTES: As of July 27. N.A.: Not available. Load funds are included for those who prefer to use a broker. <sup>1</sup>Annualized. <sup>2</sup>Audited and annualized figures except on Fidelity. <sup>3</sup>7.75% sales load. <sup>4</sup>5.25% sales load. <sup>5</sup>3.75% sales load. <sup>6</sup>3.50% sales load. <sup>7</sup>Includes a waiver. <sup>8</sup>Area code is 877. SOURCES: Lipper, New York, 877-955-4773; the fund companies.