This Love Is A One-Way Street

SYNOPSIS

- Diversification is the "Golden Rule" of investing, and investors must remain diversified across asset classes, geographies, sectors, and styles.
- Investors often over-allocate a portfolio to a single stock because they either cannot sell or choose not to sell, which creates a tremendous amount of risk.
- Concentrated holdings should be avoided at all costs because the risk they pose is far greater than any potential reward.

A WALL STREET DARLING

A true Wall Street darling came on the scene during the 1990s and rose to meteoric heights as the internet revolution began to change the world. This firm had a reputation for hiring the best and brightest, outmaneuvering their competition in highly profitable markets, and making shareholders a lot of money.

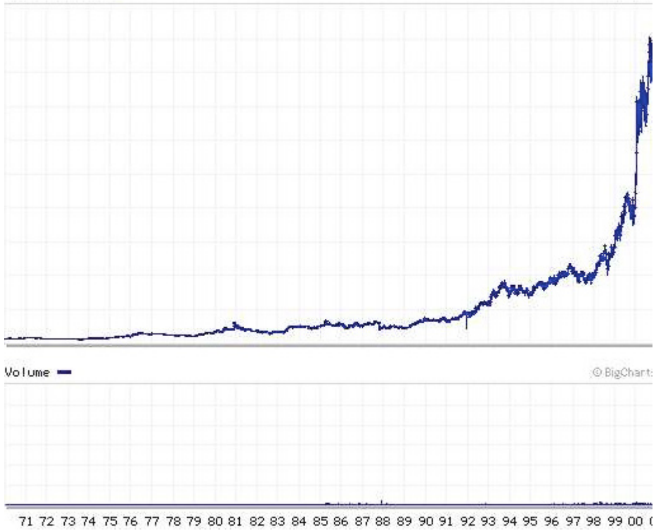
This company paid huge bonuses to top producers, which were often in the form of company stock. Since the stock price surged over so many years, employees gleefully watched their net worth skyrocket, and many became multimillionaires well before their 30th birthday.

Newfound wealth understandably creates an emotional attachment to the investment responsible for such a life-changing event, and the bond between investors and this stock only strengthened over time due to three influential forces:

1. **Management**: Executives urged employees to keep their entire 401(k) and other investment vehicles in as much company stock as they could own because the prospects of the firm were so bright. Employees were also hesitant to send any signal to their bosses that they would ever doubt management's bullish tone.
2. **Proximity**: Employees often prefer to own the stock of their employer because they believe that they have an "edge" over other investors, since they are closer to the day-to-day operations of the firm.
3. **Wall Street:** Analysts from the largest banks, who were paid millions every year for their recommendations, were in near unanimous agreement that this stock had to be owned for the long run.

Investing to build net worth over time is a process of managing risk, not taking risk.

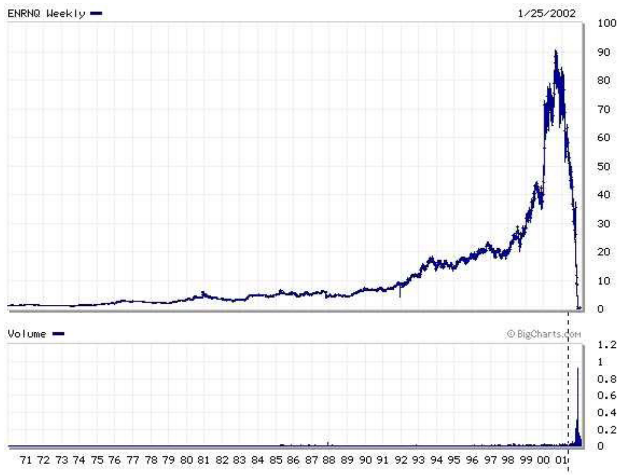
Given this backdrop, it's hard to blame employees for refusing to sell a single share, and those who remained invested enjoyed the ride in the chart below.



Source: www.bigcharts.com

The stock rose so much that it soon represented 90% or more of many employees' net worth. They became so addicted to the gains that they ignored the most basic principles of diversification.

Unfortunately, this company's name was Enron, and the chart below illustrates how billions in wealth disappeared in a matter of weeks, as the world learned that management had been committing fraud for years.



Source: www.bigcharts.com

Still to this day, questions remain unanswered about how so many smart people lost so much money and why they did not see the fraud sooner. However, as a long-term investor, I feel that these questions are not the ones that people should have been asking.

CONCENTRATED HOLDINGS ARE DEADLY

Investors accumulate a concentrated holding for several reasons. A CEO may take her company public and then have a large amount of stock that she cannot legally sell. An individual investor could have purchased Apple's stock at $3 and never sold shares. The list goes on and on.

These positions typically develop over time, and it's safe to say that accumulating a concentrated holding is a great problem to have in a portfolio. However, as this position rises relative to the overall size of the portfolio, the risk quickly outweighs any potential for future gain.

Those investors who watched their entire life savings disappear as Enron fell should not be faulted for failing to spot fraudulent activity because it is extremely rare and often conducted by a small group of bad actors out of reach from most employees and regulators.

Rather, the real question they should have asked is why such a smart and successful group of people collectively chose to put all their eggs into one basket. Enron investors may have lost their investment due to fraud, but their net worth vanished due to lack of diversification.

No matter how much conviction one may have about an investment opportunity, diversification still requires prudence. Investing to build net worth over time is a process of managing risk, not taking risk, and there is no conceivable situation where a concentrated holding is appropriate.

Each investor is unique, so it's tough to generalize about where the concentration becomes too high. But I cannot think of a situation where a single investment should ever comprise more than 20% of an individual's investable assets (excluding a primary residence).

Simply put, it's easy for the media and those who lost so much to blame Enron, but the truth is that lack of proper diversification was the real cause for the destruction of so many financial futures.

IMPLICATIONS FOR INVESTORS

Stocks get handed down through generations, some make investors very wealthy in a short amount of time, and others represent the company founder's life achievement. In each of these scenarios, emotional attachments understandably develop toward a stock in the form of loyalty, pride, and admiration.

However, mixing emotions into investing provides absolutely no upside to an investor, and any love for a stock will be a one-way street. I have lost count to the number of times I have met a once wealthy investor who watched their net worth vanish because they could not bring themselves to break an emotional bond to an investment.

Admittedly, there are instances when an investor is forced to maintain a concentrated position. For example, executives are often required to hold stock for a minimum amount of time, while others fear that selling stock would lead outside investors to believe that prospects for the firm are dire. Fortunately, strategies exist for those who cannot sell but still want to mitigate the risk inherent in concentrated holdings.

The bottom line is that breaking up is hard to do, but investors who currently hold a large position in any one investment are strongly urged to speak with their financial advisor immediately about devising a plan to either divest or hedge this risk.

Sincerely,

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