



Investment Guide Stocks & Bonds

Russian Roulette Investing

Matthew Swibel, 12.13.04

Herein, the case for defying the experts and putting a large chunk of your money on just a handful of stocks



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Famous advice from Mark Twain: "Put all your eggs in the one basket and--watch that basket." Could you do this, or something close to it, with your stock portfolio? Buy just a few companies, the ones you really, really believe in, and pray?

The very idea is poison to most of the financial planning industry. You need at least 50 names in your U.S. portfolio, the experts will tell you, and you need to diversify across different kinds of investing, too--stocks, bonds, cash, value and growth, domestic and foreign securities. If you can't get a wide-angle portfolio on your own, they say, you should invest through one or more funds that will accomplish the task.

A good mathematical case can be made for diversification. We're not going to make it here (although you can get a taste of it in the asset allocation story on page 180). Instead, this article will explore the reverse course of action. For someone who is young enough and bold enough, a plausible strategy is to diversify only halfway. Put half your money in a cheap index fund. Put the other half in a very concentrated portfolio--three to six stocks.

Tight Focus

These mutual funds hold no more than two dozen stocks. There's surely risk in that. For example, at the Oak Value Fund drugmaker Merck was a large holding and lost 40% of its value after pulling arthritis drug Vioxx off the shelves. Still, Oak Value beats the S&P 500 over the trailing three-year, five-year and ten-year periods.

Fund	5-Year TOTAL ANNUAL EXPENSES RETUR PER \$100	EQUITIES HELD
CGM Focus	31.6%	\$1.18 23
Longleaf Partners	10.1	0.91 18
Matthew 25	9.7	1.21 15
Oak Value	3.9	1.25 22
S&P 500	-2.2	

Performances through Oct. 31. ¹Annualized. Source: Lipper.

To support this radical notion we also can cite superinvestor Warren Buffett. Quoting Broadway impresario Billy Rose, Buffett has said: "If you have a harem of 40 women, you never get to know any of them very well." Or as he said on another occasion: "If you understand the business, you don't need to own very many of them."

Of course, you are unlikely to be as smart and as lucky as Buffett has been for the past 50 years. But there's no reason you can't do as well as you would with a safe portfolio of funds. Perhaps a lot better, since our scheme

gets your portfolio management costs down to a small fraction of the 1.5% or so that stock funds charge on average. The half of your money in a low-cost index fund, such as one from Vanguard, should run up expenses of just 0.2% a year. The other half, which you are managing yourself, will cost only transaction fees, a small sum if you buy and hold.

This is the model that Seong-Kwan Hong adopted last summer. He already had \$70,000 in some tax-sheltered index fund accounts. The rest of his kitty, \$40,000, had just been freed up from a disbanded real estate limited partnership in the Washington, D.C. area where he lives. Hong, 27, spends his days as a senior project manager at a mortgage finance company and nights working on an M.B.A. He decided against chopping the \$40,000 into little bits to cover any eventuality. He plunked it all down on three stocks: gold miner Newmont Mining, energy giant ChevronTexaco and high-end home builder TollBrothers. The first two will do well if inflation returns and interest rates and commodity prices rise. The builder, Hong figures, will survive higher rates because its customers are well-heeled. Thus far--and we emphasize "thus far"--the wager has worked. In price terms the S&P 500 has climbed 4.1% since July while his three-stock portfolio is up 22%.

Hong had some misgivings. "As a financial risk manager it made me feel almost ill," he says. But then he decided to "turn my brain on and think about where the world was going." Besides, he saves time by reading fewer annual reports.

If you try this at a full-service brokerage, you're likely to get a stern lecture. Merrill Lynch reminds its clients that, as the technology bust made clear, "concentrated stock positions present a significant risk to your portfolio and present problems of liquidity and diversification." Merrill's rule of thumb is that no individual security account for 20% or more of your portfolio.

Still, maybe Hong is onto something. When John Valentine, a financial planner in San Ramon, Calif. who charges a fixed percentage of equity assets, analyzed his clients' returns and volatility over 18 months, those with 24 or fewer securities had a 5% higher risk-adjusted return compared with those owning 35 or more securities. Fortunately for the few-stocks crowd, the holdings were mostly in areas his firm had successfully identified as winners, at least in the short term, such as defense, energy and mortgages.

Okay, maybe these investors were simply fortunate over a limited period. But there is some academic research that folks like Hong and Valentine can point to: an August 2004 study from the National Bureau of Economic Research. Investors with account balances of \$100,000-plus holding only one to three stocks at the beginning of each month perform 4% better over the year following a stock purchase than more-diversified investors with similar account sizes, says the NBER study by University of Illinois finance professors Scott Weisbenner and Zoran Ivkovic and University of Michigan finance professor Clemens Sialm. (You need enough money in the game for it to matter, the pros say. The performance advantage lessens in smaller accounts and all but vanishes in ones below \$25,000.) The 1991-96 study period had generally rising stocks, though punctuated by a 1994 slump.

A forthcoming study by coauthor Sialm finds that mutual funds concentrated in specific industries perform better than widely diversified funds. Take the Masters' Select Equity Fund, which directs each of its six submanagers to buy no fewer than 5 and no more than 15 favorite stocks. The fund's 4%, five-year annualized return is five percentage points higher than the S&P 500 in the same period. "Sometimes less can be more," says Weisbenner.

Sure, putting a huge slug of your wealth in three stocks is not for the faint of heart. A less radical version is to find mutual funds that are in no more than two dozen stocks. We've assembled such a list for you (*see table*).

While we hesitate to say the few-stock strategy is the magic elixir to investing success for all seasons (because no such thing exists), there's no denying it requires an involved market-watcher. Willy-nilly trading is expensive and foolish, but periodically changing weightings and holdings to track new realities is undeniably wise.

Paul Winter of Danville, Calif. adopted a similar approach in 2003, in part to reallocate \$600,000 in his equity portfolio. "I would rather have my advisers following a small number of stocks to perfection rather than a large number of stocks occasionally," says Winter, 65, a former finance manager with ChevronTexaco. Working with financial planner Valentine, he reduced the number of stocks from 47 to 27. He also exited long- and medium-term bonds for fear that rising rates would zap them.

Winter first invested heavily in education and employee training, buying shares in companies like Apollo Group. He figured that the lingering economic downturn would drive many laid-off souls to their doors. He recently

dumped them as the employment picture improved. Winter's current favorite theme: homeland security, via Taser International and Symantec. Winter says he's been beating almost anyone with a perfectly diversified portfolio. Yes, a large element of luck is behind his boast. But he's probably having more fun than the safe investors.