What Did He Just Say?

Have you ever finished someone else's sentence in your head...

and then been totally surprised by what the person actually said? So, there I was in Opelika, AL. If you are not familiar with Opelika, it is a town in Alabama just north of Auburn. There isn't a lot there, but I was young in my career and was sent there to conduct a 401(k) education session.

The uniqueness of this trip started when I first met the broker who had sold the plan to the employer. He grilled me about being from Atlanta and then dug down into my family history; he seemed to like the fact that I was born in Greensboro, NC.

When we got to the meeting and he introduced me, he said, "This is Chuck Osborne. He came down here from Atlanta, but don't worry, he is actually from the South." With this amusing introduction I began my presentation. It went smoothly until the broker interrupted me when the subject of diversification came up. He said, "What Chuck is saying is that you don't want to put all your eggs…"

You know what comes next – everyone knows this one: You don't want to put all your eggs in one basket. Except, that isn't what he said. He said, "…under the same layin' hen." It was all I could do to keep from bursting into laughter. Ever since that day, any time I hear that cliché I now finish it, "…under the same layin' hen." I suppose the difference would depend on whether your ultimate goal was an omelet or more chickens. Either way, the change made an impact.

Diversification in investing is one of the most sacred yet most misunderstood concepts. To some degree this is on purpose. In our podcast series we have been discussing how Wall Street promotes what is good for business, and diversification is probably the best example. One should never forget that Wall Street is in the transaction business: The more transactions an investor makes, the better, and no concept has led to more transactions than diversification.

This does not mean that diversifying the portfolio is not the right thing to do; However, it is often misunderstood, even by people within the industry. I recall another story a little later in my career, when a speaker at a conference said something you have probably heard before: "Diversification, as we all know, leads to reduced risk and better returns." That is not true, and I called her out on it.

In her own example she used theoretical expected returns and expected volatility, or risk. The investment with the highest expected return in her example had an expected return of 12 percent. I explained to her that there was no combination of investments in her example that would achieve a return of 12 percent, let alone exceed it. If maximizing the expected return regardless of risk was the goal, then the investor would put 100 percent of her money in the 12 percent investment.

This is all theoretical, since the actual returns and expected returns don't often match in the real world, but the issue to understand here is that diversification is about defense, not offense. If wanting to become filthy rich is one's goal, then taking a gamble on one investment is the way to do it. Don't believe me? Look at all the billionaires. Almost every single one of them is there because they put all, or at least most, of their eggs under the same layin' hen. In most cases it was a company that they founded and/or managed, but it is almost always just one company: Jeff Bezos and Amazon, Bill Gates and Microsoft. The notable exception would be Warren Buffett, who made his money through investing, but Warren Buffett's investment portfolio is notably concentrated. At one point during his rise, American Express was almost a third of his entire portfolio. In fact, if one were to take that out, then there is a good chance you would have never heard about Warren Buffett.

However, for the vast majority of us, getting filthy rich is not, in fact, the point of investing. Most of us are searching for financial independence, the ability to retire. Far more of our clients view their portfolio as a means for safety and stability than as a means for riches. This is where diversification comes to play.

Diversification is about defense. Prudent investing is risk-averse, and risk is largely controlled by not putting all your eggs under the same layin' hen. This leads to the next fallacy about diversification: that it is just about spreading out, and the more the better. If only it were that simple. Just buying a lot of investments will not necessarily diversify an investor; In the 401(k) world, we learned this the hard way during the dot-com bust in 2000.

Leading up to the bust, the trend for retirement plan sponsors was to give participants as many options as possible. Knowing they needed to diversify, participants would tend to own four or five different funds within the plan. Most often they picked funds based solely on how they were performing. At any given time in the market, the funds that are performing the best are all investing in the same things; In the late 1990s this meant they were investing in internet companies. When that bubble burst, the 401(k) participants who thought they were diversified because they owned several different funds found out the hard way that every fund they owned was investing in the same things. In other words, all their eggs had been under the same layin' hen.

This happened again in the financial crisis of 2008, this time with mortgage-based investments. The pros on Wall Street figured that it was safer to invest in hundreds of mortgages that one had no way of actually analyzing than it was to invest in, say, 20 very carefully underwritten mortgages. When fear gripped the mortgage market, the investors realized they had no way of knowing how many bad mortgages were in those securities; the diversification of hundreds of mortgages in one package became a liability as people feared they could all be bad. Panic ensued, and a full-blown crisis was at hand.

Wall Street loves the more-is-better diversification fallacy, because the more transactions an investor makes, the more money Wall Street makes, regardless of whether it actually benefits the investor. So, this more-is-better diversification fallacy continues to get pushed.

Real diversification is about carefully selecting investments that are truly different and will likely do well under different circumstances. One of the pioneers in this idea was the economist John Maynard Keynes. While he is mostly known for his economic theories, his greatest actual success was his ability to invest. Keynes ran what today would be considered very concentrated portfolios. He believed it was better to own a few companies with which he was very familiar than to own many companies of which he knew little.

However, Keynes would purposely select companies whose businesses would thrive in different circumstances. One example he used to illustrate this idea was a battery company. If he owned a battery company, he would then ask himself, "What is the greatest risk to their business?" His answer was the rising cost of raw materials, so his solution was to also

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REVIEW *of* ECONOMY

The 4th quarter 2023 GDP growth came in up 3.4 percent, and most pundits have finally given up on their recession forecast. It is hard to remember a year when so many got it so wrong. That isn't sustainable but GDPNow shows 2.5 percent growth in the 1st quarter, which is still solid growth.

The official unemployment rate was 3.8 percent through March. The labor market remains tight, and participation is growing. This is occurring while inflation is coming down, and the market is finally recognizing that good news is good news.

Inflation is 3.2 percent, based on the latest consumer price index report. The slowdown has predictably gotten slower as we are now near 3 percent. The producer price index, which tracks wholesale prices, is up only 1.6 percent over the last 12 months. +

REVIEW *of* MARKET

The market continued its broad rally. For the quarter, the S&P 500 finished up 10.56 percent, and small company stocks, represented by the Russell 2000 index, were up 5.18 percent. Growth and value both did well with the Russell 1000 Growth index up 11.41 percent while the value index was up 8.99 percent. For small companies growth did better with the growth index up 7.58 percent, and the value index was up 2.90 percent.

Bonds followed their best quarter in years with a slight decline. The Barclays U.S. Aggregate Bond index ended down 0.78 percent. High yield bonds rose 1.47 percent. Bond yields have become more attractive.

International stocks also rallied. The EAFE index finished up 5.93 percent and the MSCI Emerging Markets index ended the quarter up 2.44 percent. +

MARKET *forecast*

We have come a long way very rapidly, so a pause is in order. However, the long-term outlook still looks bright. The economy is holding up and company earnings should follow suit.

AI driven technology still has legs, and the market continues to broaden so many areas are doing well. International is very attractive from a valuation standpoint and the European economy may have bottomed out and is starting to rebound.

Bonds still look worthwhile and are behaving like bonds should. Yields are near the top of their range and should come back down in the short-term. +

invest in a raw material company. If the cost of raw materials dropped then the material company would suffer, but the battery company would benefit. If raw materials increased in price, then the opposite would happen. Either way at least one of his stocks would do well. This is diversification.

Today we use this same idea in our portfolios. Our core equity portfolio only has 20 to 30 stocks at any given time, but it is diversified. We own technology companies that do well when growth dominates the market's mindset, but we also own energy companies and banks, which do well when value leads the way.

In our model portfolios within retirement plans we invest in large companies, small companies, and international companies. They tend to do better at different times and we will tilt one way or the other depending on what is happening, but we never go all in on one type of investment. We don't have to own hundreds of funds to do this; in fact, owning that many would add nothing in terms of diversification and would likely detract from the return. We carefully select high-quality funds that are all truly different from one another. That is how diversification is supposed to work.

Prudent investing is done from the bottom-up. This means that one knows what he owns and why he owns it, and that can be done only when one diversifies appropriately. If he simply buys hundreds of stocks, then he can't really know what he owns, and this ultimately leads to financial ruin.

Prudent investing is absolute return-oriented. At any given time in the market there will be one area, or even one stock, that is driving everything. If one gets sucked into competitive investing, always comparing her returns to someone else or some market index, then she will give up on diversification and go all in on what is working today. What works today is seldom what works tomorrow, and this approach leads to

> *Diversification is not just about spreading out and the more the better.*

chasing returns yet never achieving returns. Diversification means we will own investments that are not doing great right now, yet these are often the investments that do the best in the next cycle.

This leads us to the third step in prudent investing. Prudent investing is risk-averse. This means not going all-in on what is hot at the moment, because we can't know when, but we do know that the moment will pass and when it does, it is the other investments that often save the day.

Diversification is not as simple as it may seem. If one invests in the S&P 500, then she owns 500 stocks, but the makeup of the index means that only 10 or so stocks drive the whole return, and they are all large technology companies whose fates are closely aligned, so she is not diversified. Another investor may own as few as 20 individual stocks, but if they are carefully selected, he could be well diversified. It is not about the number of investments, but about their relationship to one another.

It has been nearly 30 years since my trip to Opelika. I will admit that I made fun of it when I first heard it, but that gentleman's country twist on an old cliché made an impact. I now understand his wisdom, and I will never forget that one does not put all their eggs under the same layin' hen.

Warm regards,

Chuck Osborne

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