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# Financial Briefs

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## Principles of Stock Diversification

What professional money managers know and private investors need to learn is how to avoid depending on chance to determine their investment results. One of the first principles is to reduce risk by diversifying — spreading risk over a number of different stocks. Since over the long term even the best stocks fluctuate in value, the goal is both to avoid catastrophic losses as well as smooth out the ups and downs of your total portfolio value by always having some stocks that are outperforming others.

Almost instinctively, everyone knows this. But in practice, that notion only takes you so far. What you really need to know is this: how many different baskets are there, and how many do you need to potentially achieve the best result?

In no particular order, here are the keys to effective risk control of a stock portfolio through diversification:

**Number of stocks.** There is no preferred number of stocks that provides just the right amount of diversification. But most money managers agree that it falls in the range of 10 to 30, while some say you're okay with just five and others say even 30 isn't enough. The underlying trade-off is safety versus performance. The more stock issues you own, the lower your risk; but at the same time, the lower your potential return, as the results of the best performers get diluted by the other stocks.

**Weighting.** To diversify properly means you have to pay attention not just to the number of issues you own, but how much money you have invested in each. If you have 10 issues, but 90% of your money in one; you're not properly diversified. The more evenly you spread your

Continued on page 2

## When Should You Sell a Stock?

As difficult as it can be for some people to decide to buy a stock, it can be just as difficult — if not more so — to decide when to sell it.

In truth, there's no single rule for determining when to sell a stock. But one thing can help: knowing why you came to own the stock in the first place. If you set a specific goal, it's far easier to let a stock go once it has reached that goal.

To provide a focus here, we're going to consider two kinds of scenarios. The first is when you've made money on the stock. The second is when you haven't, either because the stock price has been flat, or it's lower than when you bought it.

**When You Have a Profit**

Short of needing money, is there any reason to sell a stock that has made a profit? The very idea seems to fly in the face of the fact that failing to let winners run is one of the most common mistakes individual investors make. Nonetheless, there are several reasons for selling some or all of a position in a profitable stock:

- **The company has fundamentally changed character and is unlikely to continue to grow in value.** This is often very difficult for casual investors to assess until it's too late, but it's not at all uncommon. Think of some leading examples from the last 20 years or so: AT&T, Enron, General Motors, and Lucent, just to name a few.

  There are at least two different ways to detect that kind of change. One is by tracking the company's fundamentals and changes in long-terms trends. Are the company's highest levels of sales, profitability, and market share more than three to five years in the past? Has it been overtaken by competitors that once were far behind? Has it cut its dividends more than once,

Continued on page 3



FR2014-0108-0004

## Stock Diversification

Continued from page 1

money among the stocks you own, the more diversified your portfolio becomes.

**Sectors and industries.** Similarly, you're not very diversified if all of your stocks are in the same sector of the economy. While you may be hedged against the risk of severe mismanagement at any one company; in general, stocks in the same industry move in roughly the same direction at the same time, because they're all exposed to the same risks in their marketplace. You achieve more risk control by choosing stocks from at least five sectors and, within sectors, different industries.

**Company size.** When it comes to stock performance, size matters. Size is measured by the stock's price times the number of outstanding shares, for a figure called market capitalization, or market cap for short. In general, over the long run, small-cap stocks produce the best returns, followed by mid-size stocks, and then large-cap stocks. As you might expect, among these three categories, small-cap stocks are the riskiest and large-cap stocks less risky and more stable. Having all three in your portfolio offers another level of diversification.

**Investment style.** There are two classic investment styles: growth and value. Studies show that over the long run they generate roughly the same total return. One difference is a matter of volatility: growth stocks tend to have wider swings in value, both up and down, than value stocks. Another is timing. Normally, they take turns outperforming each other. By investing in both at the same time, you increase your diversification benefits.

**Domestic and foreign.** Finally, you can diversify by where your stocks operate, since foreign markets are often out of phase with the U.S. market. Among U.S.-traded stocks, you can obtain more diversification by investing both in companies that operate only in the U.S. as well as in multinationals. You can also invest in foreign-based companies whose stocks trade in the U.S.

Clearly, it takes careful research and analysis to create and maintain a properly diversified stock portfolio, and there are many ways to do it. Most important, however, is to build a portfolio that can meet your goals while suiting your tolerance for risk. It's possible both to over- and underdiversify. Keep in mind that diversification does not guarantee profit or protect against loss in declining markets. Please call if you'd like to discuss this in more detail.

# Take Time to Reassess

Periodically, you should reassess your portfolio, finding ways to increase your comfort level with your stock investments. Consider the following tips:

- **Develop a stock investment philosophy.** Approach investing with a formal plan so that you can make informed decisions with confidence.
- **Remind yourself of why you are investing in stocks.** Write down your reasons for investing in each individual stock, indicating the long-term returns and short-term losses you expect. When market volatility makes you nervous, review your written reasons for investing as you did.
- **Monitor your stock investments so you understand the fundamentals of those stocks.** If you believe you have invested in a good company with solid long-term prospects, you are more likely to hold the stock during volatile periods.
- **Review your current asset allocation.** Compare your current allocation to your desired allocation. Consider rebalancng your portfolio, reallocating some of those stock investments to other alternatives.
- **Determine how risky your stocks are compared to the overall market.** You can do this by reviewing betas for your individual stocks and calculating a beta for your entire stock portfolio. Beta, which can be found in a number of published services, is a statistical measure of how stock market movements have historically impacted a stock's price. By comparing the movements of the Standard & Poor's 500 (S&P 500) to the movements of a particular stock, a pattern develops that gauges the stock's exposure to stock market risk. Calculating a beta for your entire portfolio will give you a rough idea of how your stocks are likely to perform in a market decline or rally.
- **Keep in mind the tax aspects of selling.** While you may be tempted to lock in some of your gains, you may have to pay taxes on those gains if the stocks aren't held in tax-advantaged accounts. You'll have to pay at least 15% capital gains taxes (0% if you are in the 10% or 15% tax bracket) on any stocks held over one year. If your gains are substantial, it may take longer to overcome the tax bill than to overcome a downturn in the market.
- **Don't time the market.** During periods of market volatility, investors can get nervous and consider timing the market, which typically translates into exiting the market in fear of losses. Remember that most people, including professionals, have difficulty timing the market with any degree of accuracy. Significant market gains can occur in a matter of days, making it risky to be out of the market for any length of time.
- **Remember that you are investing for the long term.** Even though short-term setbacks can give even the most experienced investors anxiety, remember that staying in the market for the long term through different market cycles can help manage the effects of market fluctuations.

Please call if you'd like to discuss this in more detail.

## When Should You Sell?

Continued from page 1

severely reduced its research and development spending, taken on unusually high levels of debt, or had its credit rating reduced several times in the past few years?

Another way to detect change at a company is to study the chart of its price changes over time. Adjusted for splits, was the stock's highest price many years in the past? Has the long-term trend line shifted to a flatter or negative slope? Is the stock having trouble piercing through resistance points that are far below its highest levels? These, too, can be signals that there are better places for your money.

- **You need to rebalance your portfolio.** One of the tools professional money managers use for raising long-term portfolio returns and reducing risk is to rebalance. That means selling some shares of positions that have grown out of proportion to your asset allocation strategy and using the profits to buy more shares of issues that have gone down in price. This has the effect of locking in some of your gains while increasing your potential return by leveraging more shares of an investment that later recovers in price.
- **You've identified a better opportunity.** This is closely related to the first reason. The difference here is that the stock you own hasn't changed its intrinsic character, but another stock with similar or better risk characteristics offers better returns, either through growth or dividends.

**When You Have Losses**

This is the easier of the two scenarios, because it can come down to answering one simple question: if you didn't already own it, would you buy it today? If not, sell. If so, keep it. If you would buy it, it's because the fundamentals haven't changed. But if you're not skilled at this assessment, you could be making a mistake.

The danger is that you may not recognize the need to sell. Sometimes, stocks go down for reasons that have nothing to do with the underlying value of the company. It could be because of a bad economy or bad news to which the market overreacts. These could actually mark opportunities to buy more shares at a cheaper price.

On the other hand, there can be very good reasons the stock has been going down and will continue to do so. If this is the case, the smart move is to cut your losses, no matter why you own the stock. You may want to prove to yourself that you didn't make a mistake buying it, or you may have inherited it from a dear relative who held it for decades. Neither of those will compensate for more losses.

The bottom line is unless you have the skills of a highly trained and experienced professional, it's best if you don't make decisions to sell a stock on your own. Please call if you'd like to discuss this in more detail.

## Reviewing a Company's Annual Report

Whether you're researching a stock to purchase or monitoring a stock you own, the company's annual report should be central to your analysis. Annual reports contain a wealth of financial information, which can provide significant insight into a company's operations. Keep these points in mind when reviewing the annual report:

- **Read the independent registered public accounting firm's report.** In most cases, you'll find an unqualified opinion stating the financial statements were audited in accordance with standards of the Public Company Accounting Oversight Board and present fairly in all material respects the financial position of the company for the last three years. It should also indicate that in all material respects, the company has maintained effective internal control over financial reporting. You'll want further details if the report indicates problems, concern's about the company's ability to stay in business, or incidences where the financial statements do not follow generally accepted accounting principles.
- **Review management's discussion carefully.** You want to feel comfortable that management is candid and straightforward about the company's results and is not glossing over problems or concerns. You should get a feel for the company's future prospects, its competitive position, and any significant risks.
- **Look for important facts in the footnotes.** Information about outstanding litigation, class action suits, derivative exposure, environmental problems, and unfunded pension liabilities can be found here, alerting you to potential problems. Changes in accounting policies will also be discussed. You can also find important information about the company's business.
- **Analyze financial trends over at least a three-year period.** Review whether sales and profits are increasing or decreasing. Also, calculate the profit margin and the return on equity, comparing these to prior years and to ratios for other companies in the same industry.
- **Review the company's financial solvency.** Calculate the current ratio (total current assets divided by total current liabilities) to track the company's ability to pay creditors over the short term. Longer-term solvency can be measured by dividing total liabilities (the total of current liabilities, long-term debt, other liabilities, and deferred income taxes) by total assets. Compare these numbers to the company's figures from prior years and to other companies in the same industry to see if there is cause for concern.

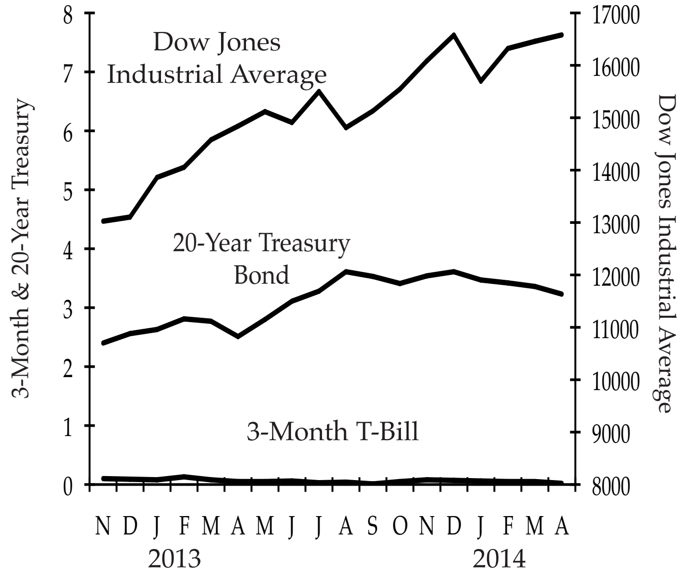
# Business Data

| Indicator | Feb-14 | Mar-14 | Apr-14 | Dec-13 | Apr-13 |
|---|---|---|---|---|---|
| | Month-end | | | | |
| Prime rate | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 |
| 3-month T-bill yield | 0.05 | 0.05 | 0.02 | 0.07 | 0.05 |
| 10-year T-note yield | 2.73 | 2.74 | 2.67 | 2.89 | 1.73 |
| 20-year T-bond yield | 3.42 | 3.36 | 3.23 | 3.61 | 2.51 |
| Dow Jones Corp. | 2.83 | 2.90 | 2.88 | 3.11 | 2.44 |
| GDP (adj. annual rate)# | +2.50 | +4.10 | +2.60 | +2.60 | +0.40 |

| Indicator | Month-end Feb-14 | Month-end Mar-14 | Month-end Apr-14 | % Change YTD | % Change 12-Mon |
|---|---|---|---|---|---|
| Dow Jones Industrials | 16321.71 | 16457.66 | 16580.84 | 0.0% | 11.7% |
| Standard & Poor's 500 | 1859.45 | 1872.34 | 1883.95 | 1.9% | 17.9% |
| Nasdaq Composite | 4308.12 | 4198.99 | 4114.56 | -1.5% | 23.6% |
| Gold | 1326.50 | 1291.75 | 1288.50 | 7.2% | -12.3% |
| Unemployment rate@ | 6.60 | 6.70 | 6.70 | -4.3% | -11.8% |
| Consumer price index@ | 233.90 | 234.80 | 236.30 | 1.4% | 1.5% |
| Index of leading ind.@ | 99.30 | 100.10 | 100.90 | 2.6% | 6.9% |

\# — 2nd, 3rd, 4th quarter @ — Jan, Feb, Mar Sources: *Barron's*, *Wall Street Journal*
Past performance is not a guarantee of future results.

**18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield**
November 2012 to April 2014




# News and Announcements

## Two Types of Diversification

When you're diversifying within your stock portfolio, there are two types of diversification to consider: horizontal and vertical.

- **Horizontal diversification** is holding stocks in, say, one industry. For example, you might own shares in a technology company index. Even though each company in the index faces similar market trends, each is also subject to unique strengths and weaknesses. Again, the principle of horizontal diversification is to mitigate risk. To use our example of the technology index, some of the companies in the index do poorly, but many of them do well — and your gains mitigate your losses.
- **Vertical diversification** involves choosing stocks across industries or markets. For example, you might own shares in a technology company, a furniture company, and an energy company (or better yet their respective indices). Mitigating risk is still your goal with vertical diversification.

The level of diversification you achieve depends in large part on the level of correlation of the companies or industries in which you invest. Correlation is a measure of how the stocks of two companies or industries move in relation to each other. Stocks that are highly positively correlated tend to move up at about the same pace and down at about the same pace. Stocks with strong negative correlation move in the opposite direction at about the same pace. Some companies and industries are less correlated than others; as a general rule, the less correlated, the better.

In general, the more broadly diversified your stock portfolio is — both horizontally and vertically — the better your balance between risk (losses) and reward (gains). If you'd like some help ensuring that your stock portfolio or investment portfolio in general is broadly diversified, please call.

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