

summaries



the official newsletter of sigma investment counselors

February 2017

Diversification – Too Much of a Good Thing is a Bad Thing

One of the major tenets of successful investing is diversification (when acting as a fiduciary, there is a legal requirement that assets be appropriately diversified by the investment professional). In the academic training for Chartered Financial Analysts and Certified Financial Planners, the content is rich and broad on the topic. The diversification mantra suggests that assets should be invested in such a way that there is exposure to differing geographies, varying asset classes (stocks, bonds, cash, real estate), company size and company sector.

Interestingly, there can actually be too much diversification. We have seen this in several portfolios recently received from new clients. Portfolios arrive packed chock full of actively managed, fully diversified, mutual funds. This makes no sense to us.

First, the redundancy is costly. Many actively managed mutual funds carry very high management fees. Not only is there duplication, but it is costly for virtually no added benefit. In addition, if the multiple mutual funds are pursuing a specific investment strategy (growth,

value, etc.) but operating broadly across the entire stock market, it is plausible that one manager is buying what another manager is selling, within the same client portfolio. Capital gains could be realized, and transaction fees generated, with no real net change in the client portfolio.

With the aforementioned typical collection of mutual funds, what we often find is that the underlying holdings, when aggregated, very often mimic an index fund. This is galling as the investment manager is charging a fee ostensibly to construct a unique portfolio and then ends up creating an index fund – at a cost far in excess of what a standard index fund fee is!

Another related issue in the portfolio management sphere was brought to our attention at a recent client meeting with the clients' CPA, the third party administrator and the actuary (the client has a defined benefit retirement plan). The actuary called out Sigma on the clients 2016 investment returns noting that they far exceeded his other clients' returns. He asked if we had made "specific tilts" on certain sectors to achieve the strong returns. We advised him that it was

local independent personal accessible
interactive creative local independent personal
knowledgeable thoughtful ethical experienced

likely that his other clients had positions in alternative investments (such as hedge funds) which had lagged badly for the last several years. We also suggested that this was predictable as we believed the strategies had limited value and therefore, did not invest in them in our own client portfolios.

In fact, hedge funds have been misclassified as an asset class, and then included in portfolios by less

discerning managers for what they incorrectly perceived to be diversification benefits. In sum, our advice regarding investment portfolio management is simple: pursue diversification but do not over-diversify, and be skeptical of investment products pushed by Wall Street brokerage firms (think not just hedge funds, but portfolio insurance, adjustable rate preferreds and exotic annuities).

Robert M. Bilkie, Jr., CFA

The views expressed represent the opinion of Sigma Investment Counselors. The views are subject to change and are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Stated information is derived from proprietary and non-proprietary sources that have not been independently verified for accuracy or completeness. While Sigma believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability.

Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

27777 Franklin Road • Suite 1100 • Southfield, MI 48034 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com