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Diversifying assets helps investors cut risk exposure

There is an old saying that diversifying assets preserves wealth but concentrating assets creates wealth.

While this may be true for business building ventures where the commitment of resources toward a singular purpose is necessary for potential success, it is by no means a recommended recipe for successful investment management.

Concentrating assets in a particular stock, industry, or asset class creates a level of risk that is inappropriate for most investors. Yet, intentionally or not, individuals often maintain disproportionately high asset concentrations that expose their portfolio to unexpected, and possibly dramatic, downward market moves.

Owning some stock in the company for which you work can be rewarding but the much-publicized plight of Enron employees, whose retirement plan imploded when Enron's stock crumbled illustrates, the downside of concentrating assets in one particular company or stock.

While the manipulative, and potentially fraudulent, actions of Enron's top executives make that situation unique, rank and file employees maintaining disproportionately large positions of employer stock in a company-sponsored retirement plan is not.

Compounding the risk of high exposure in employer stock is the fact that both an individual's current and future security are tied to the ongoing performance of a single entity. Again, Enron provides a "worst case" scenario where many employees saw both their existing salaries and company sponsored benefits disappear along with their entire retirement savings.

Some concentration of retirement plan assets in company stock may be unavoidable. Many 401(k) retirement plans only match employee contributions with company stock and may restrict any reallocation of this stock among other investment options until some distant date.

Unfortunately, studies have shown that employees often compound this concentration by additionally choosing company stock for their voluntary contributions. A 2001 survey by Hewitt Associates showed that, when offered, employer stock was by far the most popular voluntary investment option among employees.

ABC News recently reported that Coca-Cola employees directed an unbelievable 76 percent of all their voluntary retirement contributions in company stock.

The level of risk associated with concentrating stock exposure to this degree, particularly in a retirement plan, is enormous. One need not look further than our local area to see the potential impact on an individual's retirement savings.

Anyone who had concentrated their retirement dollars in Rite-Aid stock several years ago has seen their nest egg decimated. Similarly, while Tyco stock appreciated nicely during the bull market, a retirement plan holding $500,000 of Tyco on January 1, 2002 would have been reduced to less than $240,000 today;

effectively halving an individual's retirement asset base in less than two months.

What percentage of your overall assets should be exposed to a single stock or bond?

A general standard for portfolio management is no more than 5 percent. While this low a number may be unachievable when employer stock is your 401(k) plan's mandatory match or you're part of an employee stock ownership program, recognize that your potential risk increases with your percentage exposure and try to mitigate the best you can.

Concentrating a portfolio in a particular security, industry, or asset class also can occur in less obvious ways.

For instance, many investors know that various mutual funds have built-in preferences toward various investment styles, industry segments, or asset classes. But some investors mistakenly assume that the use of mutual funds mirroring a specific index, such as the Standard & Poor's 500, will effectively neutralize their portfolio's market weightings and somehow minimize risk.

When you use an index fund of any type, you are indeed buying a cross section of that particular market at that given time. However, that does not necessarily mean the index's exposure is balanced or necessarily appropriate for your circumstances.

Indexes, and consequently, index funds often carry inherent biases that most investors fail to recognize and rarely adjust for. The result can be that investors are indeed making inadvertent market bets and exposing their portfolio to unintentional risk.

For example, like most equity indexes, the S&P 500 Index is weighted by market capitalization. As the stock price for a company included in the index goes up or down, so does that company's relative weighting versus the other companies in the index.

During the most recent bull market, the rapid appreciation of technology, media, and telecommunications stocks resulted in the overall S&P 500 Index being dominated by that relatively narrow segment of industries. At the market's zenith in early 2000, this group alone represented more than 40 percent of the overall S&P 500 Index value.

Consequently, an investor who used an S & P 500 Index fund in an attempt to offset their portfolio's technology exposure or reduce their portfolio's growth-style orientation doubtfully accomplished that objective.

True diversification of portfolio assets is one of the basic ways to manage your portfolio's downside risk. Knowing what, where, and how your investments may be concentrated is a fundamental step toward effective portfolio management.

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