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The SIENA INVESTOR

A QUARTERLY PUBLICATION OF SIENA WEALTH ADVISORS

How Risky Are Individual Stocks?

In our discussions with investors, a common theme is the important role that risk plays on expected returns. Volumes of research have indicated that investors who accept the risk of equity investing can expect to be compensated with a risk premium. However, our preferred method for capturing this premium is by building an appropriately diversified portfolio of various asset class or index mutual funds, rather than by adding the risk of selecting individual equities. The same body of research has demonstrated that, by adding uncompensated single-equity risk, one is indeed likely to receive added risk, but without expected reward.

Siena Wealth Advisors moving to new office June 1

Siena Wealth Advisors, along with its affiliated companies, will be moving its corporate headquarters on June 1, 2014. The move gives our firms space for future growth in a more modern setting.

You will find us at:
11973 Sweetwater Drive
Suite A-1
Grand Ledge, MI 48837

All of our phone numbers will remain the same.

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How Risky Are Individual Stocks?

(continued from front)

2003 provided a great example of just how risky individual stocks can be. According to Morningstar there were 5,758 stocks in existence for the entire year. While the S&P 500 rose more than 28 percent in 2003, 866 stocks (15 percent) produced negative returns. Their average loss was 33 percent and they underperformed the S&P an average 61 percent.[1] In addition, the data contained survivorship bias, caused by any stocks that delisted during the year. While their returns disappeared from the database, the negative experiences had by those who held them were quite real.

Thus bull markets such as the one that began in 2003 don't protect investors from experiencing losses if the investor failed to properly diversify. The data on the riskiness of individual stock holdings is equally compelling over longer periods.

- For the five-year period ending in 2003, the S&P produced a negative return of less than 1 percent. But of the 4,823 stocks that survived the same period, almost 40 per-cent of them produced negative returns. Their average loss was 22 percent per annum, resulting in an average underperformance compared with the S&P in excess of 21 percent per annum.[2]
- For the 10-year period ending in 2003, the S&P produced a return in excess of 11 percent. Of the 2,829 stocks that survived the same period, 27 percent of them produced negative returns. Their average loss was 15 percent per annum, resulting in an average underperformance compared with the S&P in excess of 26 percent per annum.[3]

While those who purchase individual stocks can hope to select the "big winners," they also can experience the pain of severe underperformance. Studies, such as a series conducted by professors Terrance Odean and Brad Barber, have repeatedly demonstrated that investors' overconfidence in their stock-selection skills is more likely to result in high trading costs and underperformance than in a successful investment experience.

In contrast, we can point to the performance of entire asset classes during the same five- and ten-year periods ending in 2003.

- During the five-year period, the only domestic asset class that produced negative re-turns was large-cap growth (as proxied by the S&P), and it lost less than 1 percent per annum. While the asset class of large-cap value produced single-digit returns, the small-cap, microcap, small-cap value and real estate asset classes all produced annualized returns in the double digits.
- For the ten-year period, all of the aforementioned domestic asset classes produced returns in the double digits. Investors who steadfastly adhered to a prudent, diversified strategy throughout the past decade not only were well prepared to benefit from the bull market upon its arrival, but they were well equipped to avoid the kinds of severe losses experienced by many who were instead invested in individual stocks.

This is not to imply that every (or even most) passive/index investor experienced double-digit returns during the past decade. Each passive investor's experience would have been related to factors such as the degree of compensated risk built into each unique portfolio, and the investor's individual ability to remain adherent to the original investment policy by staying the course and performing appropriate rebalancing.

Nor are we implying that every investor in individual equities suffered during the same decade. As we demonstrated above, there were plenty of "opportunities" for investors to experience negative stock returns. Yet it is also highly likely that there were some investors who happened to pick just the right stocks that soared beyond their wildest dreams, and then were fortunate to sell those stocks at just the right moment before the flight swung back down.

For many investors, their primary objective is to achieve long-term goals with their investments — such as saving for their children's college education, retiring comfortably and/or leaving behind a legacy. Nearly ten years later, this same advice rings clear, building a passively managed portfolio according to a carefully designed strategy with regular, disciplined rebalancing seems a more prudent way to expect to achieve such goals than by hoping to beat the odds gambling with individual stock selections.

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[1] Craig Israelsen, Rocking and Rolling. Financial Planning, March 2004.
[2] Ibid.
[3] Ibid.

Siena Wealth Advisors
209 South Bridge Street
Grand Ledge, MI 48837
517-627-1412 Tel
517-627-5575 Fax
sienainvestor.com

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