Why your mutual fund portfolio has done so badly

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Ty Bernicke September 5, 2013

Commentary: Poor diversification leaves money on the table

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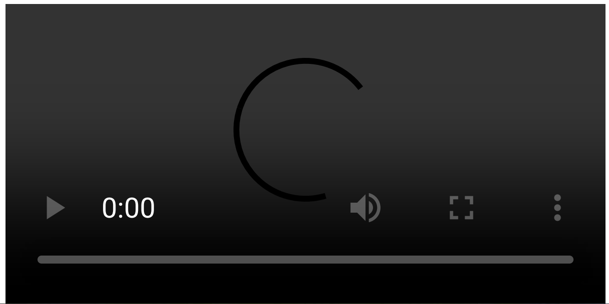
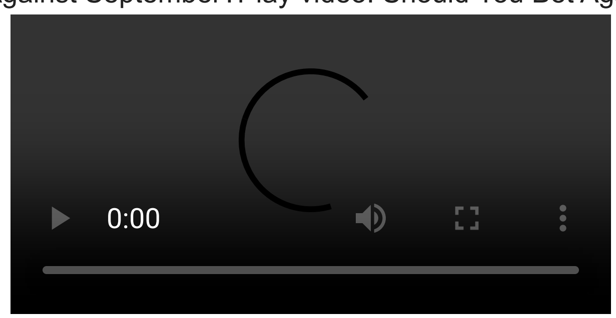
Conventional wisdom suggests a well-diversified stock portfolio will generate reasonable returns over time. Unfortunately, over the past 12 years, conventional wisdom failed. A portion of this failure stems from lack of diversification.

Many investors have a flawed perception of stock diversification due to a popular message echoed throughout the financial industry. The message implies that a portfolio allocated between large-cap, midcap, small-cap and international stocks ensures a diversified stock portfolio.



Should You Bet Against September?Play video: Should You Bet Against September?



Should you bet against September?

This widely accepted message is frequently reinforced by many professional outlets including 401(k) custodians, financial advisers, asset allocation calculators, investment companies and financial websites.

Unfortunately, this vague message provides investors a false sense of security, which unintentionally compromises proper diversification within the broad categories of the stock market.

To help ensure proper diversification, the large-cap, small-cap, midcap and international stock categories should be further divided into sectors. This is important, as each sector performs differently over extended periods. The following graph illustrates how a hypothetical $10,000 investment into each of the 10 sectors of the large-cap category would have performed from 2001 through 2012.

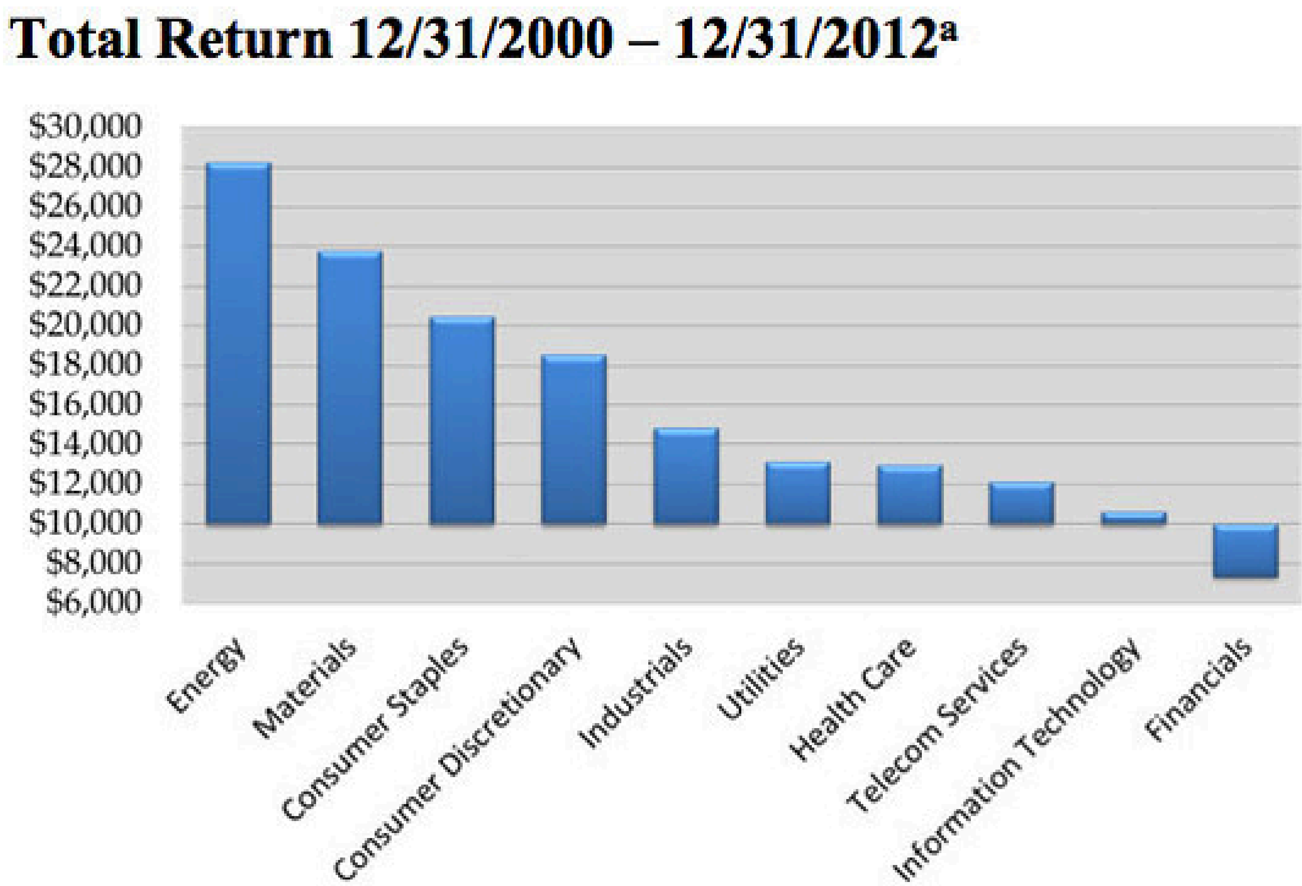


ILLUSTRATION: Bernicke & Associates Ltd.
The table above, using data from investment researcher Morningstar Inc., shows Financials and Information Technology as the weakest-performing sectors, with a loss of 26.8% and a gain of 6.3%, respectively.

The strongest performers were Energy and Materials, which increased 182.4% and 137.8% respectively, over the period. One can quickly see the distinct advantage of having money in Energy and Materials stocks as opposed to Financials and Information Technology stocks during the time horizon illustrated.

Investors who failed to have broad diversification between the 10 sectors may have unintentionally created a portfolio with heightened risk and lower returns. Unfortunately, many of the country's most popular stock mutual funds invested heavily in Financials and Information Technology stocks during this time, while investing much smaller percentages in Energy and Material stocks. Why?

Mutual funds’ structural flaw

To identify the structural flaw affecting stock mutual funds, it is important to understand the Standard & Poor’s 500 Index . This index is frequently used as a gauge for the stock market’s performance. The methodology used in constructing this index places a premium on the size of the companies chosen, with little significance placed on sector diversification. The following graph illustrates the average sector weightings of the S&P 500 index from 2001 through 2012.

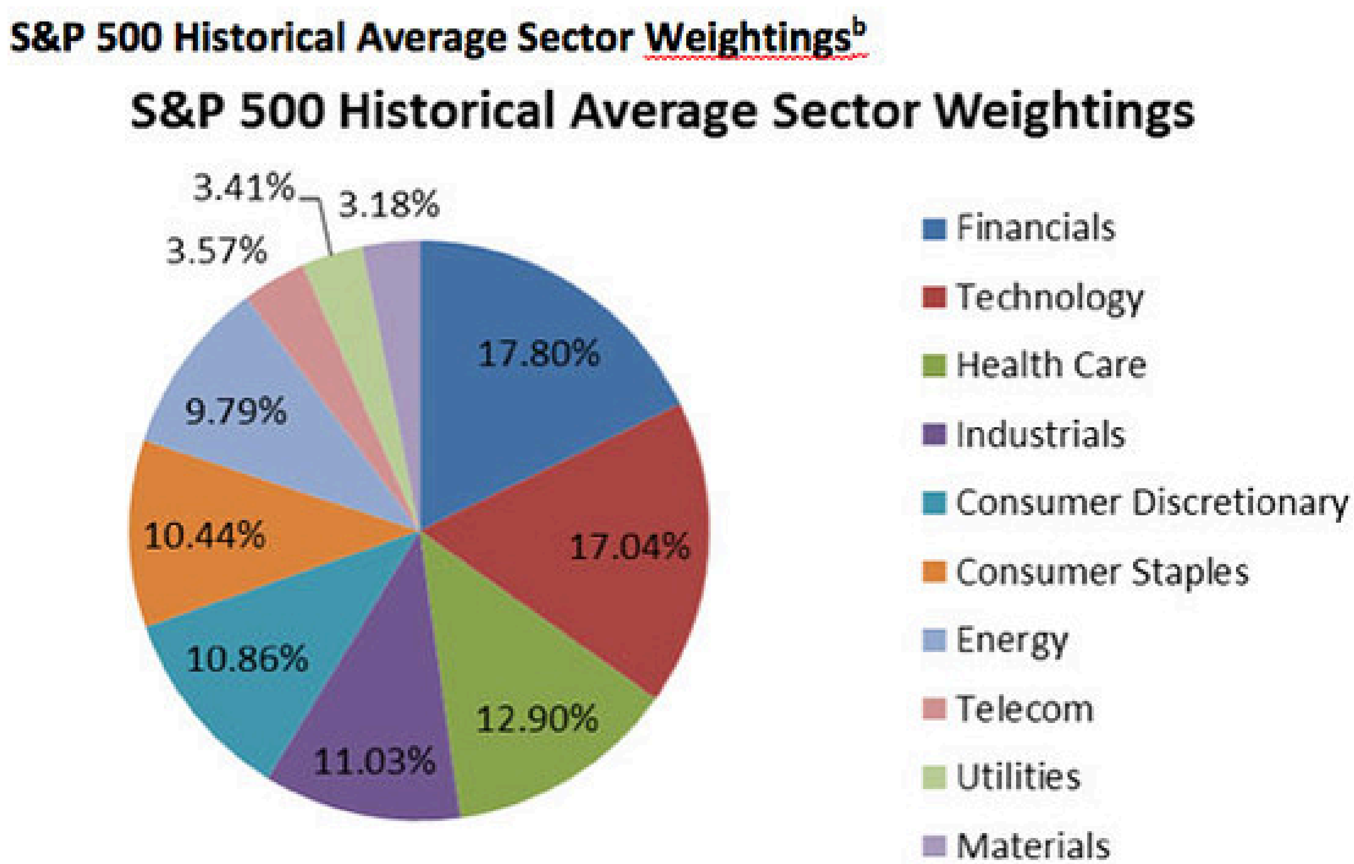


ILLUSTRATION: Bernicke & Associates Ltd.

The above chart, using data from Bespoke Investment Group, illustrates how the S&P 500 had its largest weightings in the two categories that performed the worst over the past 12 years: Financials and Technology. The index had a smaller allocation to the categories that performed the best over the past 12 years: Energy and Materials.

Unfortunately, many mutual funds invest similarly to the S&P 500, which compromises broad sector diversification. This problem may be caused by what I have dubbed the “Follow the Leader Syndrome”.

Hollow followers

Follow the Leader Syndrome stems from the investment industry's use of indexes to measure the success of mutual fund managers. Large-cap stock mutual fund managers are frequently compensated according to how well they perform relative to the S&P 500. As a result, many fund managers can face serious compensation losses if they stray too far from this measurement standard.

This fear of lost income results in mutual funds closely mirroring the S&P 500 index. The following chart illustrates how similarly large cap mutual funds are invested when compared to the S&P 500 index.

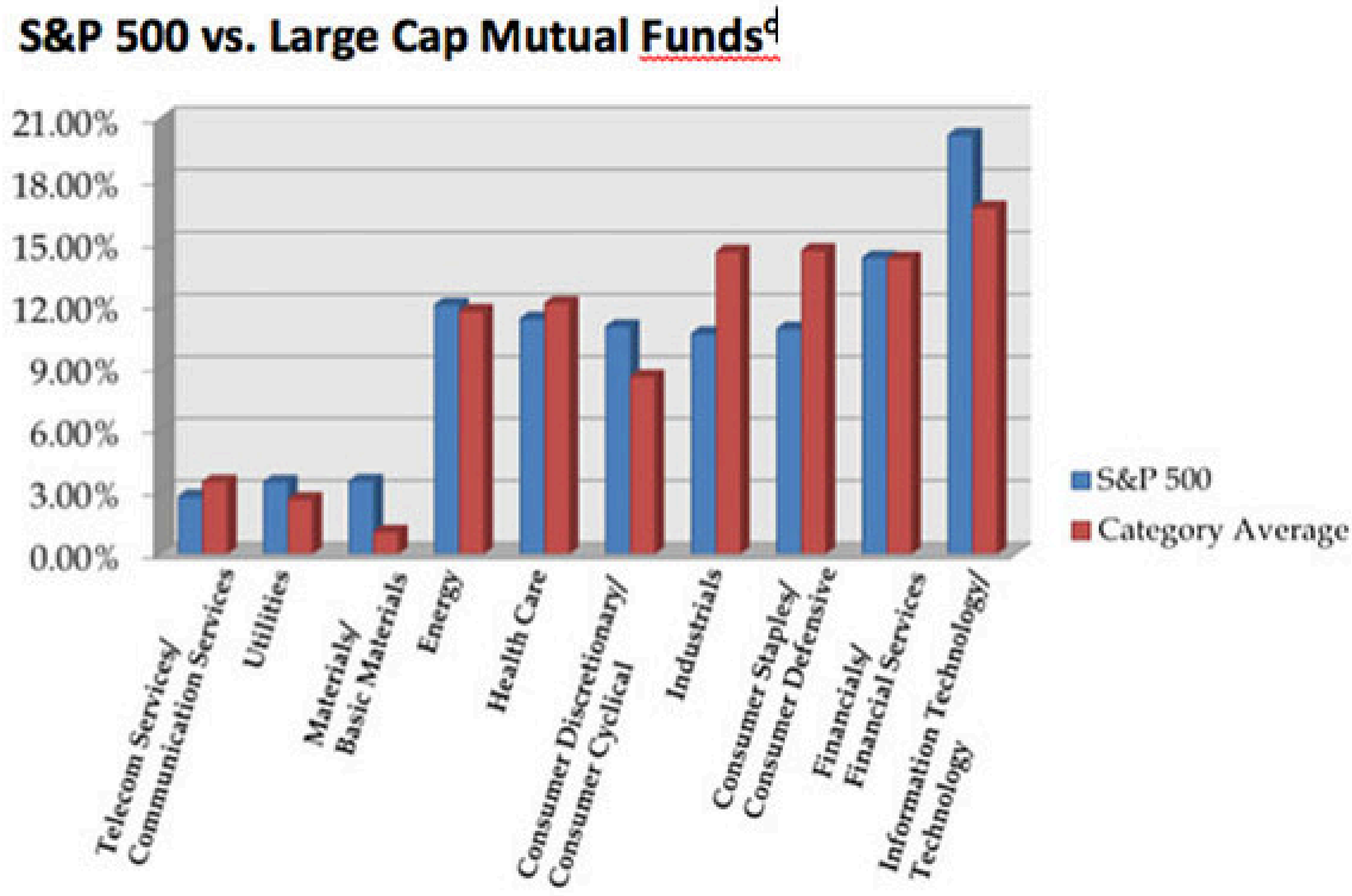


ILLUSTRATION: Bernicke & Associates Ltd.

The chart above, using data from Standard & Poor's, illustrates the remarkable similarities between the average sector weightings of large-cap mutual funds compared to the S&P 500. It's worth noting that large-cap fund managers invested the most in the two categories that performed the worst over the last 12 years, Financials and Technology.

The average large-cap fund also invested only 1% into the Materials category, which increased 137.8% during the same time frame. This chosen weighting system has plagued many fund managers who have selectively decided to overweight certain sectors at the expense of broad sector diversification. This observation is not isolated to large-cap mutual funds; it is equally as relevant with small-cap, midcap and international stock funds.

What to do

To avoid sector over-concentration in your portfolio, perform an analysis of your investments. This can be accomplished through an investment adviser or by using Morningstar. To search your funds visit Morningstar.com and locate the “Quote” field at the top of the page. After entering the name or ticker symbol of the fund, you will be brought to an overview of the fund from which you will find the sector breakdown.

By continuing this process with all of your mutual funds, you will be able to develop an accurate picture of the balance of your portfolio. This broad view can help you identify over-concentration problems.

If over-concentration is a problem, consider creating a more broadly diversified portfolio. This can be accomplished by reallocating your investments to balanced weightings among the 10 sectors. These concepts are equally as applicable for investors who prefer using individual stocks, exchange traded funds, and other investment vehicles.

By paying close attention to the categories and sectors that your investments are diversified into, you can avoid unnecessary risk.

Ty Bernicke is an independent financial adviser at Bernicke & Associates Ltd. in Eau Claire, Wisc.