

Asset Management and Diversification – Market Beating Stocks Approach

What is Diversification and Why is That Important

Diversification is a technique that reduces risk by allocating investments among various financial assets. The goal is to maximize return while minimizing risk by investing in different assets that would each react differently to the same event. The measure for how closely one asset reacts relative to another is called correlation. The best diversification comes from combining assets that have the lowest correlation.

Diversify Across Asset Classes

Investors should diversify across broad asset classes according to their tolerance for risk. Cash, Money Market Funds, Treasury Bonds, Municipal Bonds, Corporate Bonds, Stocks, and Real Estate are all examples of asset classes. Most experts would agree that cash and treasury securities carry the lowest risk, followed by bonds, and then stocks. However, assets with the highest risk also carry the greatest potential for reward. An investor's tolerance for risk will determine how they should allocate their capital across various asset classes. The more aggressive the investor, the higher the percentage of funds allocated to stocks. However, the bigger message is that investors should diversify across different types of assets to earn greater returns while minimizing risk.

Focus Is On Stocks

The Market Beating Stocks focus is to provide information to investors that are trading in stocks and options. We encourage investors to diversify across asset classes, but we do not offer recommendations on specific asset mixes investors should carry. Instead, our focus is to help investors by providing information on stocks and options. We concentrate our efforts on helping investors with the stock and options portion of their overall asset mix.

Diversification of Stock Portfolio

Just as investors should diversify across asset classes, further diversification is also important within their stock portfolio. For adequate diversification, investors need to consider the number of stocks to carry, as well as the correlation between the stocks held. For example, holding one stock in a portfolio is far more risky than owning five. However, correlation is also an important consideration. For instance, while owning five stocks is better than one, if these stocks are all from the same industry, investors will not get adequate diversification. As an example, if you hold five stocks in oil refineries, their stock price movements will likely be highly correlated, with all five moving in the same direction and trend. Investors will get better diversification by holding several stocks, but ideally the companies should represent different industries having low correlation with each other.

How Many Stocks

There has been a great debate over how many stocks are needed to reduce risk while maintaining high returns. Most conventional wisdom suggests that investors can achieve optimal diversification with 15 stocks spread across various industries. The

Market Beating Stocks view is that our strategy is optimized when holding 10 to 15 stocks. When purchasing stock, investors should allocate between 7.5% and 10% of their portfolio to each stock. That will ensure they carry 10 to 15 stocks at any one time.

Industry Diversification

It is also important to diversify stock holdings across different industries. The Market Beating Stocks strategy does not use industry as a selection criterion, so all industries are followed and represented. When evaluating stocks for purchase, we always consider industry relative to what we already own in that portfolio. In other words, if we already have several stocks in one industry, we will purchase another stock in a different industry assuming that stock met all of our other investment criteria. However, we do not try to ensure that each stock we purchase be from a different industry from the stocks we already own. Rather, we look at industry weights in our portfolios and try not to have more than 20% to 30% of our stocks from any one industry. Investors can view our industry weights in each of our portfolios from the graphs on our website at www.marketbeatingstocks.com. At first thought, an industry weight of 25% may seem high and over the long haul probably is. We do not strive for that, but would suggest that is not high given our unique strategy. The Market Beating Stocks strategy generally holds stocks for one year or less, with the average holding period closer to 4-6 months. We do not think that industry diversification is quite as important given the shorter duration and greater turnover in our portfolios. It is still important, but not as critical as it would be in a longer term buy and hold strategy.

Momentum Stock Screen

The Market Beating Stocks strategy uses momentum as one of its screening criteria. Because stocks in a specific industry tend to move in tandem, our screen often highlights industries that have been the strongest over our reporting period. In that light, our screen will often select several stocks from the same industry since they all are showing strong momentum and moving in tandem. However, we further narrow down our selections by evaluating stocks from the same industry against each other in order to find those that offer the most compelling value. Nonetheless, we will often carry more than one stock from the same industry, if both momentum and value are strong.

Don't Forget to Diversify

Diversification can help an investor manage risk and reduce the volatility of their portfolio. Remember to first diversify across asset classes, and then diversify further within each asset class. If you hold bonds, make sure you carry a mix of bonds. If you hold stocks, carry a mix of stocks from different industries. Investors can never completely eliminate risk, although diversification is a very prudent way of managing that risk.