Egg in Baskets – Who’s Watching?

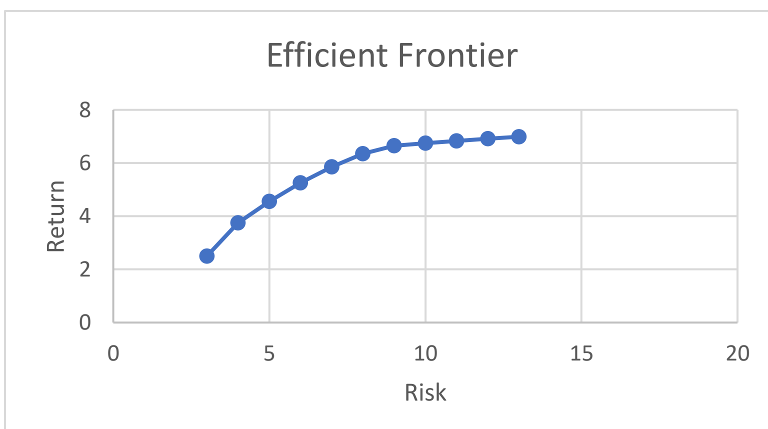
By David Barol, MPP, CLU®, ChFC®, BFA®, CFP®

Andrew Carnegie once said, “whoever told you, ‘Don’t put all your eggs in one basket’ is all wrong. I tell you, “put all your eggs in one basket, and then watch that basket.”[1]

That’s okay for Andrew Carnegie. After all, what did he ever accomplish? But Modern Portfolio Theory (MPT) does not go along with his admonition. Modern Portfolio Theory shows how risk-averse investors can construct portfolios that provide the most return for a given level of market risk. The more risk, all things being equal, the higher the return. MPT suggests[2] it is possible to construct an "efficient frontier" of optimal portfolios offering the maximum possible performance for any given level of risk.

Your role as an investor is to analyze how much risk you can handle, while still being able to sleep at night, and then construct the optimal combination of investments to fall as close to the Efficient Frontier line as possible

Risk is a measure of volatility. The more an investment fluctuates about its average return, the more risk it is said to have. Holding different types of securities may reduce the volatility of the portfolio, even though each individual security might have the same degree of volatility. Some securities zig, while others zag. If this effort at



[1]The Empire of Business by Andrew Carnegie, The Road to Business Success: A Talk to Young Men, (From an address to Students of the Curry Commercial College, Pittsburg, June 23, 1885). P. 17, Doubleday, Page & Company, New York, 1902.

[2] After all, it is just a theory,not a fact. So it can only suggest not proscribe.

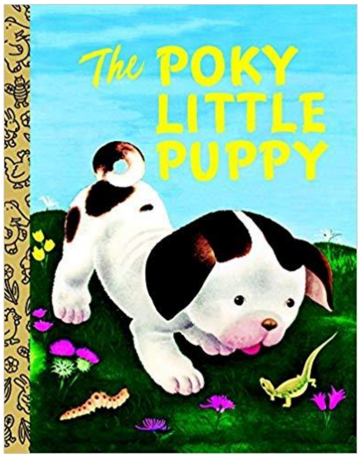
the blending of assets was successful, the portfolio should approach the Efficient Frontier.

According to Harry Markowitz, who came up with MPT, 92 percent of your investment return will come from diversification, not from individual security selection or when you purchased that security. We diversify because we don't know what we don't know. How do we know the founder of that terrific company just walked off the job? This unknown is called company risk. We avoid it by holding stocks in several different companies in the same industry.

We may know that an abrupt increase in jet fuel prices will harm the price of airline stocks. We just don't know when this might happen. We call this industry risk. This is why we diversify across industries.

What diversification cannot help, as we experienced in 2008, is when the market collapsed. No matter how well run the company, or even how cutting edge the industry, when the bottom falls out of the market and people sell in panic, everyone's boat will sink. That is known as a systemic risk. You can't diversify away from systemic risk.

Back to Carnegie. Do you know what he meant when he advised against diversification? He wasn't talking about investments. He was advising on achieving personal success, He told us to focus our attention on one thing that matters most to us. Don't join several boards, start a business on top of our day job, or try to write three books at once. When we do that, we resemble a puppy in the middle of a field filled with rabbits. We leap and bark and give chase, but we come up empty.



If you are a business owner, invest in your business. That doesn't mean you don't own other investments, you just don't want to divert too much time and attention from what you do best. Focus your attention on what is before you, and let others take care of everything else.

My friend Marie Heckler gave these keys to success:

Remove distractions;

Dream with Purpose;

Have many priorities, but one theme;

Set goals;

Create a strategy to reach these goals;

Begin today.