Is the average individual investor portfolio well diversified?

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Summary: No, the average investor portfolio is not at all well diversified. Instead of investing in broadly diversified index funds or across a large number of individual securities, many individual investors concentrate investments in a very small number of equities. This lack of diversification causes most individual investors to underperform a passive market return, while they suffer greater price volatility. The evidence below from Professors Kumar and Goetzmann indicates just how poorly diversified many individual investors are. This is regrettable, because investors can significantly reduce the risk of their portfolios through greater diversification – without a corresponding reduction in expected returns. (See: Why is diversification valuable to individual investors?) In “Equity Portfolio Diversification” Professor Alok Kumar of Cornell University and Professor William Goetzmann of Yale University analyzed over 40,000 discount brokerage equity investment accounts with over $2 billion in total assets for the 1991 through 1996 period.1 Their findings are striking. (See also this related article about this study by Professors Kumar and Goetzmann: What is the cost to individual investors of sub-optimal portfolio diversification?) Account sizes indicated that these accounts represented a significant portion of these investors’ total assets. These accounts were not just “play money,” but instead were being held for retirement or other significant future expenses. The equities purchased by these self-directed investors tended to be in large consumer products and technology companies with well-known names – many of the same firms that constitute the S&P 500 index. The vast majority of these portfolios were very significantly under-diversified. Younger, less wealthy, and non-professional individuals held the least diversified portfolios. On average, investors’ portfolios held four stocks in 1991 and 7 in 1997. About 25% of accounts held only one stock and about half held one or two stocks. Their portfolios were highly volatile with 75% of portfolios exceeding the volatility of the S&P 500 market benchmark. Because they held a few more stocks, investors with larger portfolios were slightly better diversified, but still highly undiversified. Professors Kumar and Goetzmann stated, “while the number of stocks in a portfolio is a useful heuristic for identifying the degree of diversification, it is not sufficient to determine the diversification characteristics of a portfolio. Two individuals may both hold the same number of stocks in their portfolios, but one may hold stocks with low correlations among them and the other may hold strongly correlated stocks confined to a single industry – the volatility of these portfolios will certainly differ.”2 Professors Kumar and Goetzmann found no evidence that investors in this sample paid any attention to the covariance of stocks within their portfolios. Furthermore, mutual funds accounted for about 15% of account holdings, and there was no indication that less diversified investors compensated by holding more in mutual funds to achieve greater diversification. Professors Kumar and Goetzmann found that when individual investors attempted to become more diversified, they did so in a naïve and relatively ineffective way. Many investors in the sample traded actively, and as a result, they were even less diversified. The study authors suspected that some individual investors were over-confident and had unjustified illusions of control over market outcomes. The authors argued that “familiarity with a certain set of stocks may further exacerbate the illusion of control where investors may fail to realize that more knowledge or more information does not necessarily imply control over the outcome (i.e., returns earned by the portfolio).”3 In summary, the typical investor did not seem to show any evidence of attempting to diversify their accounts beyond “naïve” approaches like holding a few more different stocks, even if they had larger investment account balances. Professors Kumar and Goetzmann stated that these investors were “unable to (or unwilling to) choose stocks in a manner consistent with the goal of diversification.”4

These related articles may also be useful to you: ->What is investment portfolio diversification? -> Investment securities markets do not pay you for the risks of holding individual common stocks and bonds ->What is a well-diversified portfolio? ->Can a limited number of equities provide complete portfolio diversification? ->How many common stocks are needed for a well-diversified portfolio? -> How do changes in common stock price volatility affect diversification? ->How does the size of the common stock risk premium affect diversification? ->How many mutual funds are needed for a well-diversified portfolio? – evidence ->How many mutual funds are needed for a well-diversified portfolio? – a commentary 1) Kumar, Alok and William Goetzmann. “Equity Portfolio Diversification.” Yale International Center for Finance Working paper No.00-59, November 2002: 1-43

2) ibid, p. 7

3) ibid, p. 31

4) ibid, p. 5