HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

<u>Stock Diversification</u>

Last quarter we addressed Asset Allocation, the process of dividing a portfolio among major asset categories in order to reduce portfolio risk. This quarter, we will focus on diversification <u>within</u> the equity segment of a portfolio.

We believe adequate stock diversification can be achieved as follows:

> *Invest in approximately 20 individual stocks, with no more than 2 stocks in any one industry.*

The goal of stock diversification is to reduce the overall fluctuations and risk in a portfolio. The argument for diversification is akin to not putting all your eggs in one basket. Few people would be comfortable having their entire equity portfolio invested in a single stock. There might be tremendous upside potential, but there would also be enormous downside risk. The same holds true for investing in a single market sector (having a portfolio of all technology stocks, for example). In a well-diversified stock portfolio, volatility is limited because not all asset prices move up or down in value at the same time or at the same rate.

For example, oil stocks usually react favorably to an increase in the price of crude oil because, quite simply, a large portion of oil company profits depend on oil sales. Within the oil sector, however, the stocks of companies that focus exclusively on the exploration and production of oil might increase more than those companies with more diversified operations including refining and marketing of oil products. Conversely, the stocks of companies that are energy intensive, such as chemical companies, might decline on news of higher oil prices. Because prices of stocks over a cross-section of industries do not move in the same direction at the same rate, volatility is reduced when an optimum number of stocks are held in a variety of unrelated industries.

So, how many stocks must be included in a portfolio to achieve diversification? The results of academic research based upon a study of real portfolios indicated the major benefits of diversification are achieved quickly. More specifically, the results of one study indicated that roughly 90 percent of the <u>maximum</u> benefits of diversification was achieved from portfolios consisting of 12 to 18 randomly selected stocks (source: Reilly, Frank K., Investment Analysis and Portfolio Management, Fourth Edition, p.276).

At Hutchinson Capital Management, our goal is to construct a portfolio of approximately 20 equal-sized stock positions. Typically, we do not hold more than two stocks in one particular industry category. In our view, with 20 holdings we are able to capitalize on the benefits of diversification, yet still have each stock represent a meaningful position in the portfolio.

The "Chinese Menu" Approach

The typical approach to diversification as expressed in most investment literature is to determine the appropriate asset allocation (i.e. how much to put in stocks, bonds, and cash) for a portfolio, and then decide how to invest in each asset class. For the stock portion of the portfolio, this means dividing funds among several sectors or markets such as U.S. large cap (value and growth), U.S. mid cap (value and growth), U.S. small cap (value and growth), international developed markets, international emerging markets, hedge funds, private equity, and other subgroups of stocks. This goal can be accomplished by choosing a group of mutual funds or a number of specialized investment professionals.

Developing a stock portfolio like this becomes much like selecting dishes from a menu at a Chinese restaurant – we'll take a chicken dish, a vegetable dish, a beef dish, and a noodle dish. The rationale behind investing in stocks in this manner is that no one is smart enough to figure out which area will do well or poorly in any given time period. Using this approach, one is likely to lose money with some investments but make money in others. The net result, hopefully, provides a decent, positive return.

Problems with the "Chinese Menu", and variations of this approach, are as follows:

- **Lack of Market Knowledge** - Each market or investment area (U.S. equity, international developed markets, emerging markets, etc.) has its own unique investment characteristics. When decisions about where to invest and when to get in and out are left up to you or a generalist, as in the "Chinese Menu" approach, decisions are often made without the required expertise. This can result in poor timing (when to get in and out) and very mediocre performance results. Invariably, one or more of the different markets will have unforeseen bad performance which significantly hurts overall portfolio results.

- **Susceptibility to Trends** - Lack of market knowledge also makes one vulnerable to following the current fashionable trend. How often do we see mutual fund firms marketing funds targeting the latest "hot" markets (e.g. technology, emerging markets, hedge funds) as a way to "diversify" a portfolio? The problem here is that by the time an investment product or market has a strong, positive track record, it is probably too late to invest in that area. The result is buying at or near the top when assets are overvalued. What follows is usually a decline, and after a period of disappointment, investors sell at or near the bottom.

An example of this is the recent trend of investing in emerging markets portfolios. Over the past year and a half many investment professionals have very eloquently advocated that investors "diversify" their portfolios by moving money into emerging market investments. In 2005 approximately $397 billion dollars were invested in this area, and up to May 11 of this year an additional $490 billion more was invested in this same area. Both these amounts were all time records! The irresistible lure was the rising standard of living in these countries.

Then, in the four week period between May 11, 2006 and June 8, 2006, emerging market stocks as a group dropped 20% in value. This was a very awkward period for those who had chosen to give significant weight to investments in emerging markets.

What happened to cause this 20% downturn? Investors followed a trend without fully understanding the markets and risks involved. These markets lack liquidity. Often, there are only a dozen or so large liquid stocks available for investment in an emerging market country. Funds poured into these markets, drove prices up, and went into many smaller less liquid investments. Then, when investors decided to exit, they could not sell quickly enough. There were no buyers! Prices began to fall further and further, and many were stuck with illiquid emerging markets holdings.

Trend-following investors in emerging markets also overlooked the facts that emerging market countries often have governments that are not stable and could change overnight, that there are no strong central banks or security regulatory authorities to control the flow of money in and out of investments, that there are no fair court systems, and there is no free press to broadcast egregious actions by special interests. Furthermore, in the emerging market debt area, the average spread in yield between U.S. government debt and emerging market debt is currently a mere 1.7% (versus 14.9% at the end of the emerging markets collapse in 1998). The fact is that the level of risk in these markets is substantial and investors are not currently getting paid enough to bear that risk. It is imperative that all risks and potential rewards are thoroughly considered and understood before making an investment.

- **Lack of In-depth Specific Company Knowledge** - Buying low (near the bottom) and selling high (near the top) requires in-depth knowledge of specific companies, and confidence in your research abilities. One must thoroughly understand the magnitude of the downside risk and the potential upside rewards. Unfortunately, most advisors and investors just cannot develop the confidence to go into areas when they are unpopular (such as technology stocks today) because they really do not understand the outstanding values that exist when stocks are depressed. Instead, they invest when all is going well – i.e. when prices are near the top!

- **Poor Management of the Total Portfolio** - If the total stock portfolio is segmented such that several different managers are involved, each handling a different portion of the portfolio, the collective performance of the investor's total stock portfolio becomes very difficult to monitor efficiently. In the case of a taxable investor, such fragmentation makes efficient tax management of the portfolio as a whole nearly impossible (timing capital gains, harvesting losses to offset gains, etc.). If mutual funds are the vehicle of choice, these problems are worse as there is virtually no direct manager/client communication, no knowledge of the individual investor, and little possibility for tax efficient management.

- **Excessive Fees and Transaction Costs** - Many advisors and investors who are in constant search of new diversification strategies fail to give ample consideration to the higher fees and transaction costs that may be involved. The fact is, there are significant transaction costs associated with moving money to different types of managers and different strategies, and this will have a negative impact on the performance results of anyone who follows trends, chases performance, or tries to play in too many different markets or asset classes. Furthermore, higher risk strategies (such as investing in emerging markets) generally come with both higher transaction costs and higher investment management fees. Not only does it cost more to trade these instruments, but managers of these strategies typically charge fees of 1.5% to 2.6%! Compare this to the 1.0% fees charged by a typical U.S. equity manager. As you can imagine, these hefty fees can eat away at performance numbers that are already mediocre compared to the risks.

Our Approach To Stock Diversification

At Hutchinson Capital Management we follow a clear and consistent stock selection strategy. This includes limiting a portfolio to approximately 20 equally-weighted stock positions in a cross-section of industries, and following a disciplined research process that ensures we thoroughly understand a company and its management before we decide to buy. Our philosophy is straight-forward – we buy undervalued stocks of high quality companies with clearly defined issues that have caused the stock price to be low, and we are convinced the management has or is taking definite steps to correct the problem. We stick to this philosophy regardless of what is taking place in the overall stock market, the economy (both domestic and worldwide), or the geo-political climate. We do not follow fads or try to make a "quick buck".

We employ a similar diversification approach within the bond segments of our clients' portfolios. We buy high quality bonds, with maturities spread over an eight-year period, resulting in bond portfolio durations (average amount of time to recover both interest and principal) of approximately 3.50 years. We invest only in the US bond market, and we buy only government, agency, municipal, and corporate bonds that we know well and can be easily bought and sold. Diversification in a bond portfolio is achieved by spreading out the maturities. Although our bond ladder (spread of maturities) has been shortened over the past several years – from 10 years to 8 – our process of evaluating and buying bonds has not changed. We have simply shortened our durations in response to the lack of return currently available from longer bonds (the additional risk is not rewarded), and our growing concern about rising inflation and its impact on interest rates in general.

Within the bond segment of a portfolio, we believe this high quality, laddered approach achieves adequate diversification.

In all our portfolios, our goal is to earn reasonable returns for our clients over long periods of time while minimizing downside risk.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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