The Choice of Individual Stocks

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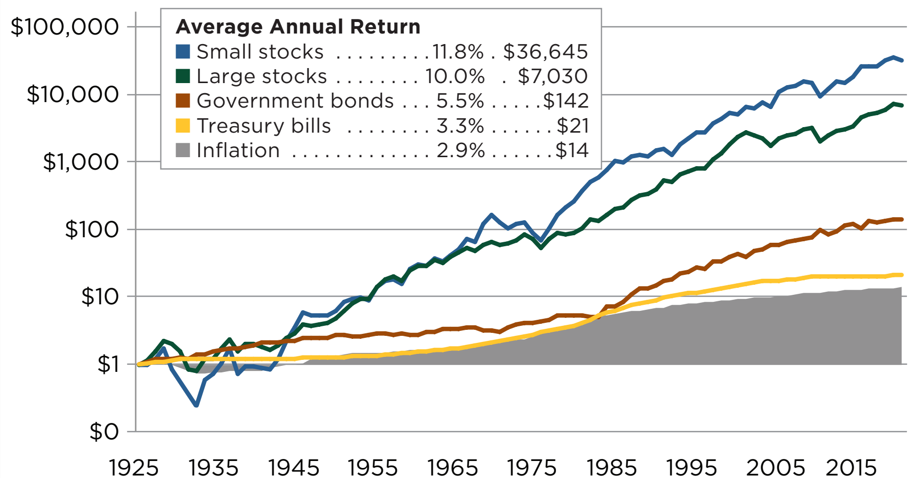
Depending on your goals, you have a number of investment choices. Stocks can play an important role in a portfolio because they are potentially an effective way to grow principal and can help you meet your long-term goals for retirement, college and other life expenses. Stocks may also provide rising income, which can help you combat inflation over time. You can choose to own stocks in a number of ways: individual stocks, mutual funds and exchange-traded funds (ETFs). Deciding how you want to own stocks is an important starting point in building your portfolio.

Individual stocks offer many potential benefits, including growth of principal and dividends, customization and tax management, but require setting realistic expectations and managing risk. If you have enough money to invest, are willing to accept the risk and want a high degree of involvement, individual stocks may be a good choice.

The Benefits of Individual Stock Ownership

Potential Growth of Principal – Stocks have a long track record of providing higher returns than bonds or cash-alternative investments. Between 1926 and 2018, the S&P 500 returned an average of 10.0% annually, significantly outpacing bonds, T-bills and inflation, as shown in the chart below. In addition, for any 10-year period invested, stocks outperformed bonds and inflation more than 80% of the time.[1] Of course, the prospect of higher returns with stock ownership does carry additional risk.

Long-term Investment Returns vs. Inflation (1926–2018)



Source: Morningstar Direct. All rights reserved. 12/31/2018. Hypothetical value of $1 invested at the beginning of 1926. Calculations assume reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. Categorical representation for the data in this chart is disclosed on the final page of this report.[2] Past performance is not a guarantee of how the market will perform in the future.

Inflation is a risk for long-term investors since it reduces their purchasing power. Historically, inflation has averaged about 3% per year but has been much higher at times. Investments that provide the potential for growth of principal, such as stocks, can potentially offset the impact of inflation.

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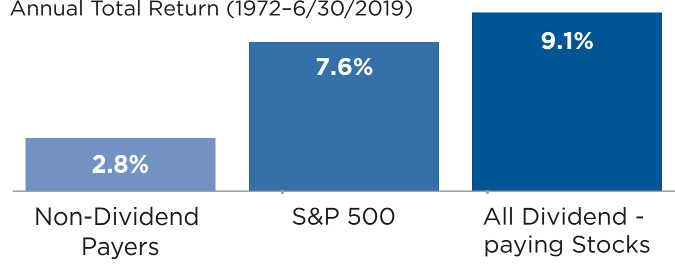
Rising Income – Not only do stocks provide the potential for growth of principal, but dividend-paying stocks can help meet the need for income. Rising income, achieved through dividends that grow over time, can have a meaningful impact on your total return and can help you meet long-term goals. From a quality standpoint, we believe these stocks offer greater consistency and less volatility than nondividend-paying stocks. In addition, owning investments with increasing dividends has been an effective way to help offset the rising cost of living.[3]

The chart below shows the difference in total returns – growth plus dividends – for individual stocks based on the company's dividend policy. Dividend payers provided a return five times higher than did non-dividend payers. And stocks that both paid and grew their dividend over time had the best returns historically.

The Importance of Rising Income



Source: Ned Davis Research. Uses indicated annual dividends on a rolling 12-month basis. Past performance may not be an indication of future results. The S&P 500 is an unmanaged index and is not meant to depict an actual investment. Does not include transaction costs or taxes. Dividends can be increased, decreased or eliminated at any point without notice. Copyright © 2019 Ned Davis Research, Inc. All rights reserved. Further distribution prohibited without prior permission. Data 12/31/1971–06/30/2019.

Tax Control – Individual stock ownership may be a way to meet your financial goals while reducing your tax burden.[4] With individual stock ownership, you control when to buy and sell. If it makes sense for your portfolio, you may choose to wait to sell a stock that has a capital gain until you are able to produce a capital loss to offset it. Under current tax rules, it may be possible for you to defer the recognition of any gains by gifting appreciated stock. In the case of death, the beneficiary receives the "stepped-up" cost basis on appreciated stock to reflect the market value at the time of the transfer. For this reason, individual stocks are often seen as a tax-efficient way to transfer wealth to the next generation.

While tax rates are subject to change, there are some differences you should keep in mind. Currently, long-term capital gains tax rates are lower than ordinary income tax rates. When appropriate, consider holding stocks longer than a year to take advantage of this lower rate. The current taxation of qualified dividends at long-term capital gains rates is also a consideration in determining whether to own dividend-paying stocks.

Cost Control – If you buy stocks with the intent to hold them for a long period of time, it can be a very cost-efficient way of investing. But it's important to remember that the more trades you make, the more commissions and fees you'll pay in a brokerage account.

Liquidity – Individual stocks can be bought or sold on any given trading day and generally are one of the most "liquid" investments. Liquidity, or the ability to quickly sell an asset, can be important to meet planned or unexpected needs. Stocks that trade on a major exchange, such as the New York Stock Exchange or Nasdaq, tend to be the most liquid. It's important to understand that prices of most investments, including stocks, constantly fluctuate, and there is no guarantee as to their prices or liquidity.

Customization and Transparency – Individual stock investors are very involved in the decision-making process when determining which stocks to own and at what prices to buy or sell. You can fully customize your stock portfolio and select only the companies you want to own. Some investors may want to avoid owning more stock from the company they work for because it's already part of their retirement plan. Or you may wish to avoid a company based on social policy issues. Regardless of the reason, individual stocks allow you to choose exactly which companies you want to own.

The Trade-offs

Individual stock ownership may offer benefits that fit your investment needs, but you should consider the trade-offs to owning a large number of individual stocks. If you want the control and involvement of choosing which stocks to own, individual stocks may fit your needs. However, if you don't want to be as involved in the investing process, individual stocks may not be appropriate for you. Also, if you have a smaller amount of money to invest, you may not be able to own enough stocks to diversify effectively.[5] You should consider the risks associated with owning stocks, including loss of principal and greater volatility, and set reasonable expectations for performance.

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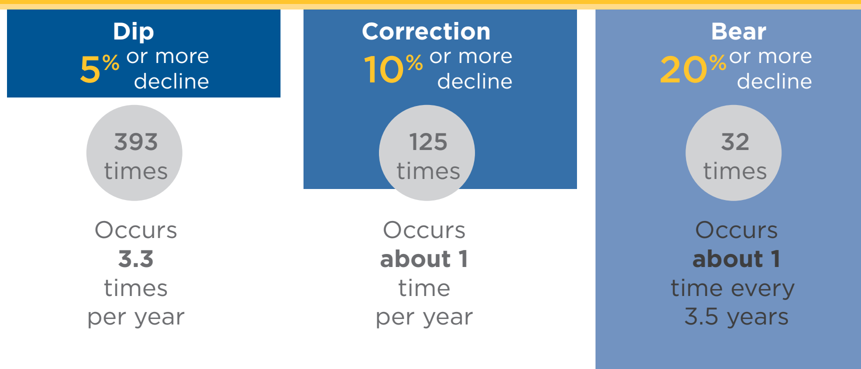
Know the Behaviors of Successful Investing

Understanding how stocks behave is essential to being a successful investor with individual stocks. For stocks, it's especially important to keep long-term expectations in mind and not become overly concerned with short-term price movements. Investors who aren't expecting normal dips and price corrections often sell after prices fall. Stock market declines are common, occur without warning and end unexpectedly. Drops in stock prices of 10% or more occur about once a year, and more severe bear markets happen every three to four years on average. If you have a long-term time horizon, these declines can be opportunities to buy stocks at lower prices.

Declines in the Dow Jones Industrial Average (1900–2018)



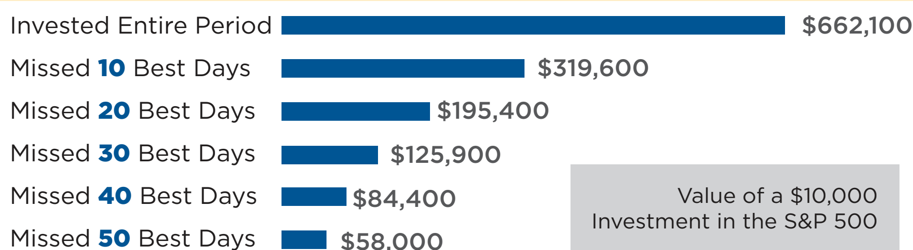
Source: Ned Davis Research, 1/2/1900–12/31/2018. Copyright © 2019 Ned Davis Research, Inc. All rights reserved. Further distribution prohibited without prior permission. Past performance is not a guarantee of what will happen in the future.

In the chart below, it is clear that successfully timing the market – pinpointing a perfect time to buy and sell – is nearly impossible. An investor who stayed out of the market for just the best 10 days historically experienced significantly lower returns than someone invested the entire period. Waiting to buy into the market until all of the news sounds good and selling out of the market when things feel bad is likely to be an unsuccessful strategy.

Our advice is to set realistic expectations for your stock portfolio's behavior to help you remain objective and stay invested during uncertain times.

Market Timing Doesn't Work

Number of Best Days Excluded (1980–2018)



Source: Ned Davis Research. Total return includes dividends. These calculations do not include any commissions or transaction fees that an investor may have incurred. If fees were included, it would have a negative impact on the return. The S&P 500 is an unmanaged index and is not meant to depict an actual investment. Rounded to the nearest $1,000. Past performance does not ensure future results. Copyright © 2019 Ned Davis Research, Inc. All rights reserved. Further distribution prohibited without prior permission. Data 12/31/1979–12/31/2018.

Setting Realistic Return Expectations

How much return is reasonable to expect from equities? Answering this question is difficult, since no one can tell you exactly what your investment will be worth in the future. But it is an important question to address before investing in stocks. It's human nature to want the highest possible return. However, while the best things in life may be free, the best returns in the stock market are not. The higher the expected return, the more risk you should expect.

In the short term, stock market returns can be heavily influenced by any number of factors, including interest rates, political unrest, economic trends and news events. Over the long term, though, a stock's total return is tied to its earnings growth and the dividends it pays. The earnings growth rate of U.S. companies in the S&P 500 has historically averaged between 5.0% and 6.0%,[6] but we expect slightly slower growth of 4.0% to 5.0% going forward. Looking at the dividend side of the equation, we believe a dividend yield expectation in the range of 1.5% to 2.5% is a useful starting point. In combination, an expected total return for U.S. stocks in the 5.5% to 7.5% range should provide a good gauge for setting expectations for that piece of your portfolio.

Remember, returns should not be expected to occur as a smooth line, but with good and bad years along the way. In fact, although the stock market has averaged a nearly 10% return over its more than 90-year history, it has rarely hit 10% in a given year.

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Use Diversification to Help Manage Risk

There are many different risks to consider when investing. Business risk, liquidity risk (how easily an investment can be sold for cash) and political risk are some examples. However, over the long run, we believe the greatest risk is not reaching your financial goals. As you work toward your goals, we believe it is critical to understand your willingness to take risk, then set realistic expectations and take steps to manage risk.

How Many Do You Need?

Portfolio Stock Allocation	Number of Stocks Recommended
50% or more	25 to 30 stocks
25% to 50%	15 to 25 stocks
25% or less	15 stocks

Source: Edward Jones Investment Policy Committee.

If you want individual stocks to make up a large part of your equity portfolio, we recommend between 15 to 30 stocks across various economic sectors to be properly diversified. By owning a single stock for only one year, you'd have a 95% chance of achieving a return between -78% (a loss) and 98%.[7] However, if you held a portfolio of 15 stocks, the return would narrow to a -1% to 21% range. By holding those 15 stocks for five years instead of one, the range of return narrows again to a 5% to 15% range.[7] The more stocks you own over a longer period of time, the narrower the range of potential returns and the less volatility you should experience.[5]

Individual stocks give you greater control and customization to meet your goals but need greater attention. Discuss your options with your Edward Jones financial advisor and determine if individual stock ownership is a fit for your needs.

U.S. Recommended Sector Weightings

Diversifying by sector is a first step in helping to manage risk. You can further diversify among different subsectors or industries and company size (large, mid or small cap). Adhering to a diversified strategy can help reduce volatility and smooth out portfolio returns over time.[5]

Sector	Weighting
Communication Services	10%
Consumer Discretionary	9%
Consumer Staples	9%
Energy	5%
Financial Services	16%
Health Care	15%
Industrials	9%
Materials	3%
Technology	20%
Utilities	4%

Source: Edward Jones Investment Policy Committee.

1 Source: Morningstar Direct, 12/31/2018.

2 For the purposes of the "Long-term Investment Returns vs. Inflation" chart, fees, commissions and charges are not included and would have a negative impact on investment performance. Categories are represented by the following:
- Small-company stocks represented by the IA SBBI US Small Stock Index.
- Large-company stocks represented by the IA SBBI US Large Stock Index.
- Government bonds represented by the IA SBBI US LT Govt Index.
- U.S. Treasury bills represented by the IA SBBI US 30 Day Tbill Index.
- Inflation represented by the IA SBBI US Inflation Index.

3 Dividends can be increased, decreased or eliminated at any point without notice.

4 Edward Jones, its employees and financial advisors are not estate planners and cannot provide tax or legal advice. You should consult with a qualified tax specialist or legal advisor for professional advice on your situation.

5 Diversification does not guarantee a profit or protect against loss.

6 Source: Standard & Poor's.

7 Source: Winter 2000 *Journal of Investing*, Ronald Surz & Mitchell Price. In the case of a one-stock portfolio, the tracking error is 45%. Tracking error is a measure of how closely the portfolio follows the index and is measured as the standard deviation of the difference between the portfolio and index returns (such as the total return of the S&P 500). It measures specific, or diversifiable, risk as the standard deviation of returns away from the market. The tracking error Surz and Price observed was used to create the range of potential expected returns with the formula 10% +/- 1.96 tracking error for 95% confidence (two standard deviations).

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