Digging Deeper into Stock Diversification

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Diversification is one of the best ways to help reduce risk in a portfolio, and you can apply several layers of diversification to potentially improve your portfolio's success.

The overall objective for your portfolio is determined by your long-term financial goals and comfort with risk. From there, the first important layer of diversification is how much to invest across each asset class within equity and fixed-income investments. A properly diversified portfolio requires digging deeper, beyond asset allocation, to the underlying layers.

Understanding Your Equity Options

To dig deeper into the equity piece of a portfolio, we believe a good balance can be achieved by having exposure to domestic and international companies, as well as companies at various stages of growth and size (large-cap, mid-cap and small-cap stocks). We generally recommend owning international and small-cap stocks through mutual funds to help achieve proper diversification efficiently. If you have enough money to invest, are willing to accept the risk and want a high degree of involvement, individual stocks can be a good choice with which to build your equity investments.

If you plan to own some mix of individual stocks and mutual funds, it could make sense to start with mutual funds so diversification can be accomplished with a smaller initial investment amount. Dollar cost averaging – or contributing a set amount of money at regular intervals – is another strategy you can use to help purchase the recommended number of stocks over a period of time.[1]

5%

Avoid Overconcentration

We suggest a 5% rule of thumb to avoid owning too much of a single investment. Often, one large single holding can dominate the performance of the entire portfolio. Remember, even "good" companies can fall on tough times.

Diversification Guidelines: Layering Your Portfolio

If you've decided to own individual stocks, use the following guidelines to help diversify them:

- **Target How Many to Own –** By holding a sufficient number of stocks, you can reduce the variation of the portfolio's performance. We recommend owning a minimum of 15 stocks to reduce the volatility of returns in your overall portfolio.
- **Diversify by Investment Category –** Follow the portfolio objective's target recommendation for the proper mix of stocks within the Growth & Income, Growth, and Aggressive categories. Exposure to companies of various sizes and types can improve your portfolio's diversification.
- **Balance Across the Sectors –** The performance of stocks within different sectors will vary every year. We recommend you build your stock portfolio across all sectors of the economy. Start with the largest sector weightings and maintain balance between sectors that are more sensitive to the economy and more defensive sectors.
- **Go Deeper with Subsectors –** You can further diversify by owning stocks within a variety of subsectors and potentially limit the impact from specific industry risks.
- **Consider Price Movement –** Take into account the tendency of a stock's price movement relative to the market. We recommend owning a balance of stocks with different price movements to help smooth performance over time.
- **Maintain Your Balance –** Make sure your portfolio stays aligned with your objective by reviewing on a regular basis.

Setting Your Target: How Many Stocks to Own

If individual stocks are to make up the majority (50% or more) of the equity part of your portfolio, then you should plan to own 25 to 30 stocks. At a minimum, we recommend owning at least 15 stocks to avoid over-concentration in any single stock or sector.

We recommend the following number of stocks, depending on the allocation of your equities among individual stocks, exchange-traded funds (ETFs) and mutual funds:

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.

As you increase the number of stocks in your portfolio, you effectively narrow the range of potential returns and lower the overall volatility of your portfolio.[2] This is the essence of diversification. Let's take the example of investing $100,000 in just one stock for a one-year period, when the market return is expected to be 8%. Based on this study's findings, as summarized in the table below, you'd have a 95% chance of achieving a return between -80%, for a loss of $80,000, and a gain of 96% or $96,000. That's a wide range of possible outcomes.

If instead you held a carefully selected portfolio of 15 stocks, the range of returns would narrow to a 3% decline up to a 19% gain. While diversification does not prevent losses, it can be an effective tool for narrowing the range of potential outcomes. The results of the study shown in the chart below also illustrate that time in the market matters. Staying invested over longer periods of time increases the potential for a more predictable range of returns.

Potential Returns Range vs. Portfolio Size

Equity Portfolio Size	Potential Range of Returns Assuming an 8% Market Return	
	1-year	5-year
1 Stock	-80% to 96%	-31% to 47%
15 Stocks (Diversified)	-3% to 19%	3% to 13%
30 Stocks (Diversified)	0% to 16%	4% to 12%

Source: Edward Jones, Surz and Price.[2]
Table is for illustration purposes only and does not reflect a specific investment.

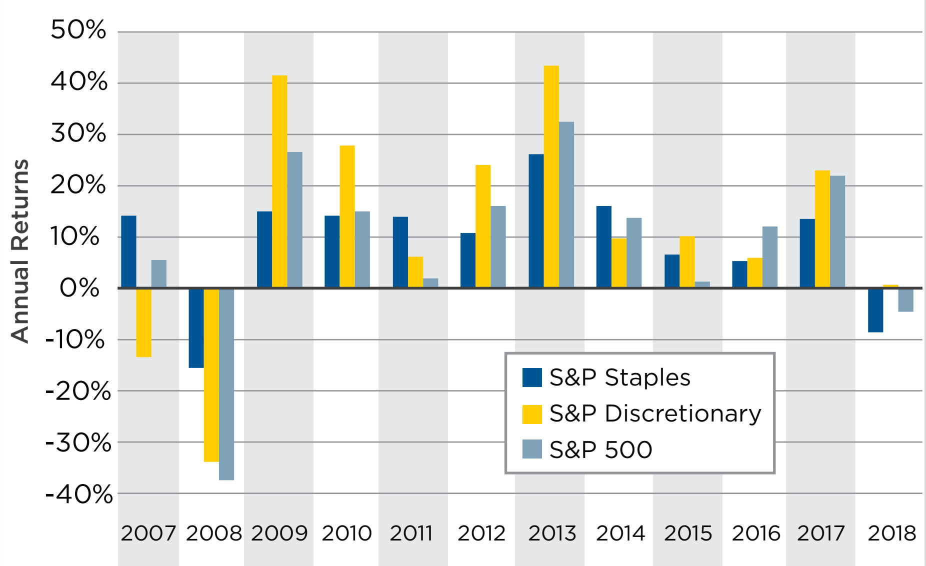
Balance Across the Sectors

Our stock research and recommendations are focused primarily on domestic large-cap and mid-cap companies. We recommend investors divide their stock holdings by sector to achieve a similar alignment with the U.S. economy. We suggest investing the largest portions of your portfolio within the sectors that generate the majority of consumer, business and government spending. Following the recommended sector weightings on Page 4 can help protect your portfolio from issues or events that have an outsized effect on a particular sector or stock.

If you are building a portfolio of stocks over time, it is important to know how the sectors complement one other. Some are highly correlated, while others perform differently depending on the economic backdrop, investor sentiment and the economic outlook.

Accurately predicting the performance of each sector is difficult. Let's use the Consumer Staples and Consumer Discretionary sectors as examples. Defensive sectors such as Consumer Staples often perform best when the market and the economy are weak, while the sectors with more sensitivity to the economy, such as Consumer Discretionary, typically perform their best when the market and economic data are strong. This was evident throughout the past decade, including 2009, 2010 and again in 2013, as Consumer Discretionary (along with similar sectors) outperformed and provided the offense for the portfolio. In weak or negative return years for the market, such as in 2008 and 2011, Consumer Staples stocks shone through and took the defensive role for the portfolio.

Offense vs. Defense



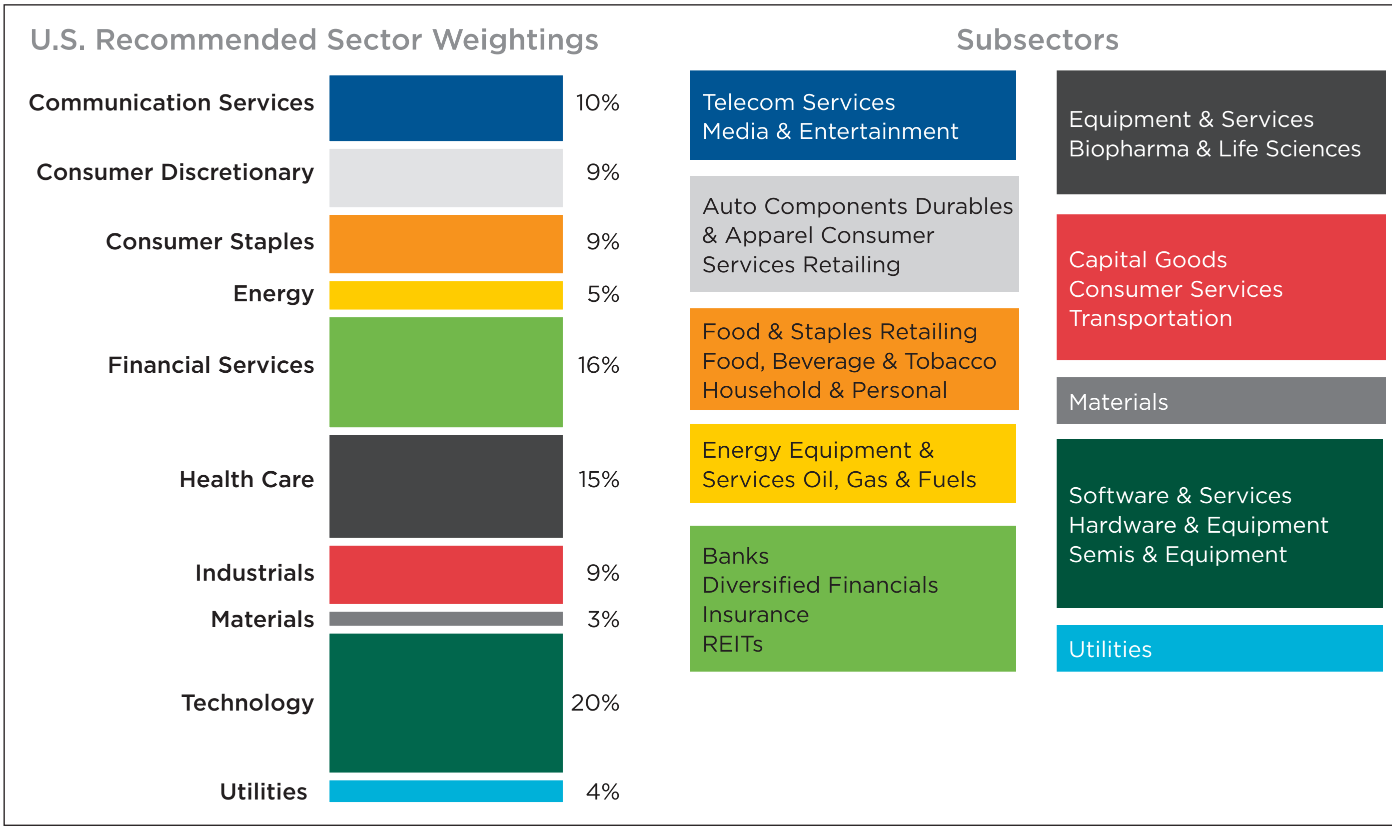
Source: Bloomberg and Standard & Poor's. Past performance is not a guarantee of future results. The S&P 500 is an unmanaged and is not meant to depict an actual investment.

We recommend building your stock portfolio by starting with the largest sectors and balancing between sectors that are more sensitive to the economy with those that are less sensitive, with a goal of owning stocks across all 10 major sectors. For example, a Technology stock would be a good complement to a defensive holding in Health Care, representing two of the largest sectors.

Finding Sector Balance

Sector Defense	Sector Offense
Consumer Staples	Technology
Health Care	Industrials
Utilities	Financial Services
	Consumer Discretionary
	Materials
	Energy
	Communication Services

Source: Morningstar Direct and U.S. Department of Commerce.



Source: Edward Jones Investment Policy Committee.

Subsectors: A Deeper Layer of Diversification

We use subsectors to group industries and companies around common business drivers (i.e., consumer demand, economic forces, competition) that influence business results and stock performance. Stocks in the same subsector often perform similarly, while stocks in different subsectors are often less correlated to each other. For example, if you own a banking stock and are adding a second stock within the Financial Services sector, we recommend it be from a different subsector, such as insurance.

Consider a Stock's Price Movement

When building a stock portfolio, consider the tendency of a stock to move up and down relative to the market. Stocks are classified as either above average, average or below average. Stocks with above-average price movement are often growing faster than the average company and/or reside in industries that are more economically sensitive. A stock with an average price movement shifts similarly to the average stock in the S&P 500 Index. And a stock with below-average price movement fluctuates less and is less sensitive to the economy. We recommend owning a balance of stocks with different price movements to help smooth performance over time.

Being Balanced

Portfolio diversification means owning investments that complement one another's performance instead of moving up or down together. Diversification does not guarantee a profit or protect against loss in declining markets, but by owning stocks across differing sectors and subsectors, your portfolio should be better equipped to lower risk and smooth returns over time.

1 Dollar cost averaging does not guarantee a profit or protect against loss. Investors should consider their financial ability to continue the purchases through periods of low price levels.

2 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). The S&P 500 is an unmanaged and is not meant to depict an actual investment. 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 8% +/– 1.96 tracking error for 95% confidence (two standard deviations). An 8% market return expectation is assumed as the starting point in the calculation of potential return ranges shown.

Calculations do not include any commissions or transaction fees that an investor may have incurred. If these fees were included, it would have a negative impact on the return.

There are special risks inherent in international investing, including those related to currency fluctuations and foreign political and economic events.

Small-cap stocks typically react with more volatility to market fluctuations than large-cap stocks.

Investments in stocks fluctuate with changes in market conditions and may be worth more or less than the original investment when sold.

Past performance is not a guarantee of future results.

