Dimensional

OUTSIDE THE FLAGS

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The Wrong end of the Telescope

An entire branch of the financial media exists to tell people what stocks to buy. For some reason, many people still think this works as a wealth management tool.

Each year, Australia's 'Smart Investor' magazine runs a front cover feature called The Good Stocks Guide. It's an exhaustive, and exhausting, analysis of which stocks offer the best prospects in the year ahead.

Supposedly, 'investors' are supposed to spend hours poring over eye-glazing analysis of price-earnings ratios, return on equity, quality of management and industry breakdowns before running off to their brokers to put their money down.

In 2012, Smart Investor chose as the core of its preferred portfolio a group of 25 blue-chip stocks—"the companies you need to know".

A year later and it turns out there were indeed a few strong performers in the 25 chosen ones, including CSL (a total return of 72%), Ramsay Health Care (+45%), Westpac Bank (+40%), Commonwealth Bank (+34%) and Cochlear (+33%).

But guess what? There were also some woeful performers. In a strong year for the share market in Australia, 'Smart Investor' also chose Newcrest Mining (a total negative return of 24%), Metcash (–11%), Challenger (–10%) and Worley Parsons (–6%).

In an overall market that offered double digit returns for the year, there were also plain ordinary performers in the "good stocks" list like Harvey Norman (+8.5%), ASX (+8.1%), Orica (+7.5%) and David Jones (+7.1%).

Overall, the magazine's portfolio of 25 blue chips would have given you a total return of just under 19% for the year, before brokerage costs of course.

Now while that might sound pretty good, keep in mind that just by passively owning the S&P/ASX 200 index last year you would have enjoyed a return of 20.3%. And this is without worrying about brokerage costs or wasting precious hours studying company accounts or chasing news about your chosen stocks.

What's more, you would have exposure to 200 stocks—not just 25, which means your portfolio would have been significantly more diversified than taking your tips from a magazine journalist.

With a broadly diversified portfolio, your investment returns are overwhelmingly driven by the market itself, not by the idiosyncratic risks of individual stocks.

You also have the option, if your risk appetites allow, of tilting your portfolio to smaller companies or those with low prices relative to fundamentals. Again, the focus here should be on the overall dimensions of risk, not on individual stock stories.

Investing this way is akin to taking only those risks you need to take, concentrating on factors within your own control (like costs) and focusing on the big picture returns that capital markets deliver.

Otherwise, all you end up doing is looking through the wrong end of the telescope.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

For more articles, visit Dimensional's client site at my.dimensional.com/insight/outside_the_flags

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