

Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.

Determining How Much to Allocate to Each Investment

The influence any single investment has on your overall portfolio's performance depends significantly on its position size. Position size is the percentage of portfolio dollars allocated to a specific investment, such as a stock. To use a simple example, say an investor has a \$100,000 portfolio invested in 20 stocks. Under an equal-weight scenario, each stock would have a position size of 5% of the overall portfolio's value. In other words, \$5,000 would be invested in each of the 20 stocks.

Focus on Dollars, Not Shares

Notice how the number of shares is not discussed. When allocating, focus solely on the amount of dollars and not the number of shares. If you focus on shares, you could end up buying 100 shares of a stock trading at \$20 and 100 shares of a stock trading at \$50. The dollars at risk are \$2,000 and \$5,000, respectively—a big difference. If you allocate \$5,000 to each stock rather than being concerned with how many shares you are buying, the amount of money at risk is the same for the two stocks.

Going back to the original example of a 20-stock portfolio, if the price of any one of the stocks were to drop to \$0, the maximum downside risk posed to the portfolio by that particular stock would be 5%. Since your dollars are distributed evenly, each stock's downside risk is also evenly distributed.

What if you held a smaller number of investments? The percentages would change accordingly. In a portfolio equally distributed between five stocks and five funds, each investment would pose a maximum downside risk of 10%. The lower the number of investments you hold, the larger the risk each investment poses to your portfolio. Conversely, holding more securities (stocks, bonds, etc.) and funds decreases the risk each investment poses. This is why diversification depends in part on holding an adequate number of securities.

Periodically Take Action to Maintain Balance

Equal weighting only lasts temporarily since stocks and bonds, and funds that hold them, do not move in lockstep.

Within asset classes, some securities rise, some stay flat and some fall. Even if all of the individual investments in your portfolio do move in the same direction, the magnitude of the price changes will differ. This causes the position sizes to be ever-shifting.

Small divergences are not significant. If one investment accounts for 6% of the portfolio's overall value instead of 5%, the proportionately higher risk posed by that one investment is not significant. The transaction costs of constantly bringing the portfolio back to an equal weighting can negate the benefit of making small changes. This is why even equal-weighted funds tend to limit how often they adjust the position sizes of each investment.

Bigger divergences, however, deserve attention. If one asset class (e.g., stocks) realizes higher returns than another asset class (e.g., bonds), the risk profile of the portfolio is altered. During a bull market for stocks, the portfolio could become too tilted toward stocks and incur more price volatility than you are comfortable with. In such situations, it makes sense to rebalance across asset classes, which, in this example, entails shifting dollars out of your stocks and your stock funds and buying bonds and bond funds.

Within an asset class, if one or two investments perform exceptionally well, their position size could become exceptionally large. This could not only lead to greater investment-specific risk (the potential damage to your portfolio caused by a significant drop in one security or fund), but also alter your portfolio's overall allocation. In such scenarios, first check to see if the investment's valuation is too high. If so, consider selling it outright. If not, consider reducing the position size down closer to the average dollar amount of your other holdings to reduce the investment-specific risk.

Establish Reasonable Bands of Divergence

The key is to establish bands of divergence wide enough to let your winning investments run, but not so wide that position sizes become too large. A useful rule of thumb is to adjust your asset class allocations when they move five or 10 percentage points off target. For individual investments, consider paring or selling them when their position size grows beyond 2.5 times the average size of your other investments.

—Charles Rotblut, CFA, Editor, AAI Journal