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When I'm asked why I don't buy individual stocks, my answer is that I want to avoid adding more layers of risk than I need to.

Let me explain.

When we buy large groups of stocks (an index fund, an exchange traded fund, or even actively managed funds with many holdings), we still have "market" risk. For example, in 2000-2002 and in 2008, it did not matter if you were diversified, your investments dropped markedly in price. The entire market went down.

The next layer of risk is that of a sector, or a country or an industry. Perhaps you thought that oil would keep climbing in price last year and you concentrated investments in the energy industry. I'd suspect that your more concentrated focus is turning out poorly right now, as adding the layer of industry risk worked against you. The market may go up, but your industry bet can go down.

Adding yet another layer of risk is the result of buying an individual company. Investors in General Motors stock in 2007 were exposed to market risk, industry risk and then company risk. Despite the fact that the markets came back and the automobile industry recovered from the great recession, GM stock did not recover and its holders were wiped out.

Why add the risk of owing individual companies with their three layers of risk. Are you smarter than the person selling it to you? Are you smarter than the millions of professional investors around the world? Are you informed more deeply than the legion of investors that watch that particular stock over long periods of time?

The majority of actively managed stock funds under-perform their index fund competitors. Here we see full-time professional investors backed by extensive groups of analysts unable to pick out those individual companies from an index successfully. Do you think you can do better in the long run?

Buy the market in order to make reasonable long-term returns. There are times in which a strategic asset allocation makes sense, as markets can be clearly overpriced at times (real estate in 2006, tech stocks in 1999, perhaps domestic long-term bonds now). But adding the three layers of risk involved in single stock investing seems destined to fail for the vast majority of investors.

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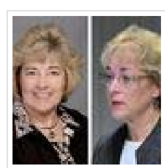
- 

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