PACIFIC WEALTH MANAGEMENT®

The Pitfalls of Individual Security Selection

The allure of stock selection or "stock picking" attracts many investors. Picking stocks can be wildly lucrative, as Warren Buffett has demonstrated or as anyone who invested in Apple or Costco during those companies' infancies knows. On an emotional level, it gratifies and thrills to invest directly in a company and see it thrive. It makes us feel smart to identify a winner, and we enjoy participating directly in a company's success.

While there is no universally "right" way to invest, investors should know that individual stock selection carries more risk than relying instead on asset class allocation. Asset class allocation means investing across different classes of securities, rather than focusing on specific securities within the asset classes. It means allocating a percentage of assets respectively to equities, bonds, cash, and sometimes commodities. Because thoughtful asset class allocation spreads risk through diversification, the odds of long-term success increase when contrasted with the person who invests solely in individual securities.

Stock picking is challenging for many reasons. First, it takes time and focus to monitor the individual securities. No company or industry does well all the time and it is difficult for even expert investors to anticipate and act on challenges to an individual company's financial well-being. Betting that a struggling company will recover can work out, but sometimes it does not. Even when a company is destined to succeed, many investors do not have the discipline to hold a stock that has declined in value for a variety of reasons which can result in emotional decision making and selling at the worst time. Other individual investors simply do not have the aptitude for successfully navigating the volatility of security selection. An additional complexity that adds challenge to individual security selection is the influence of other financial markets on specific companies.

Charley Ellis, renowned financial author, professor, and former chair of the Yale University Endowment states: "As more and more players participate, it becomes more and more likely to be efficient. And as it becomes more and more efficient, it's harder and harder to do better than just settling for the average or the index. Moreover, the stock market is now connected to the debt market, which is connected with the oil market, which is connected with every commodity market around the country. And all of them are connected to all the different currency markets. So there's an unbelievable, phenomenal change in the way in which prices are being set by the participants in the market." Even seasoned investment professionals who have access to a wealth of data and resources generally advise against stock picking as a sustainable long-term investment strategy.

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Pacific Wealth Management agrees with the work of La Jolla native Harry Markowitz who championed diversification in his "Portfolio Selection" paper (1952). He won a Nobel Prize award for his work in developing Modern Portfolio Theory (MPT). MPT argues that the best way to maximize returns and mitigate risk is to have an ideal mix of high risk/potentially high return investments and low risk/low return investments. While Markowitz's work focused on stocks, his emphasis on diversification shaped portfolio management in general and promotes the practice of allocating appropriately to different asset classes rather than trying to select individual securities.

While stock picking can seem glamorous and potentially high-yielding, we do not recommend it for our clients' long-term financial security. It is simply too difficult with too many potentially compromising variables for most people to achieve competitive returns via individual security selection. Pacific Wealth Management manages well-constructed, balanced portfolios that reflect our clients' own risk tolerance and investment time horizon. Our disciplined approach to diversification is designed to smooth out volatility over time, striving for greater risk-adjusted performance than one typically experiences concentrating on individually selected securities.

We are here to answer your questions and to discuss how we may help you reach your financial goals.

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