WINNING YOUR PERSONAL WAR: SIMPLIFICATION VERSUS DIVERSIFICATION

By Ernest McDaniel

Today’s subject is taken from my forthcoming book Three Miracles and Seven Secrets and addresses the second of the seven secrets to preserving retirement assets and income.

We all want to make as much money in investments as we can, as fast as we can, and, of course, without any risk. We also want to eat lots of ice cream, never exercise, never gain weight, and die peacefully in our sleep at age 110 after running an easy eight-minute mile earlier in the day. We don’t get what we want.

We have to make choices between this or that action to get, respectively, this or that consequence. Even then, we get the certain consequence only if we are fortunate, because the universe offers no absolute guarantees, even though the FDIC, FDA, FCA, CIA, various other government agencies, and lots of other people and institutions do make assorted promises. We make reasonable choices, at least some of us do, then we wait and see. One of the tough choices we make is between simplification and diversification.

Wouldn’t it be wonderfully simple to keep all of your wealth in the bank? There, however, you might give up a great deal of potential return, incur taxes unnecessarily, possibly subject your funds to probate and suit risks that could otherwise be avoided-and that’s just the short list of negatives. While certainly you should have sufficient funds for emergencies and short-term needs in a bank or similar institution, most people feel that investing funds elsewhere in order to build and preserve retirement funds is a virtual necessity.

So, do you instead keep all your wealth in a single stock, maybe the one you are most familiar with-you know, stock with the company where you worked for thirty years? It’s a simple enough strategy, and this company may be one you know better than others, so there may be no great amount of research necessary for you to feel comfortable with the choice. Single decision, no research effort, comforting familiarity-certainly sounds inviting. Why is this not such a good idea? Here’s a one word answer: Enron. To better explain, though, let me add this: WorldCom, Lucent.

Let’s suppose you do decide you should put your money into many stocks, not one. What kinds of companies might you buy stock in? Providers of what products or services? What size companies? Based in what nation? With how much debt and what kind? With what suppliers and what customers and what secure, long-term contracts? With what dividend and earnings and price history? Whoa, now you have a bunch of decisions to make. This isn’t simple at all. Maybe you should hire an expert. Wait, isn’t that what mutual funds do, provide specialized expertise for managing a variety of investment choices?

You may want to consider bonds as well as stocks in your efforts to diversify. Which ones? U.S. government, foreign government, corporate, municipals? Each has its own risks and rewards. With each, as with any investment, you give up certain qualities in hopes of gaining others. With each,

there are a multitude of considerations. This is definitely not simple. Some experts consider bond investment management more complex than that of stocks. A mutual fund containing bonds, or even both stock and bonds, may be worth considering.

Okay, which mutual fund out of the approximately 14,000 should you use? Or, which of several? Choosing mutual funds may not be particularly simple or easy. Costs are a consideration, and obviously the history of net results is also. (However, history does not necessarily predict the future. Look at the difference in results between the 90’s and the New Millennium for most stock funds!) How about relative risk? How about choosing many funds, diversifying styles, diversifying between kinds of risks in an effort to reduce total risk? (Not to be redundant, but remember, there are no guarantees.)

Does all this simplification with mutual funds begin to seem, well...complex? Need help simplifying more? A broker may help you choose mutual funds. Be sure to choose your broker carefully. There are asset management companies that make these choices for you based on your general guidance and risk propensity. Choose the asset manager carefully. Variable annuities typically provide a menu of separate accounts that serve a similar function to mutual funds and do offer diverse choices, often management as well. Choose carefully the variable annuity and the representative from whom you purchase it.

There are many other investment categories besides those mentioned here. For example, there are gold, gold stocks, commodities, options, real estate investment trusts, limited partnerships, indexed and fixed annuities, and even holding cash in hand--not necessarily all U.S. dollars. The mix of possibilities is limitless and the decisions complicated beyond most laymen’s awareness. Our discussion today is not intended to be a recommendation of any particular investment or strategy over another.

In summary, it is clear that simplicity has substantial risks-you may pay a price, possibly a catastrophic one. Complexity also has substantial risks; nevertheless, a degree of complexity may be necessary in striving for higher returns while also striving to reduce risk of loss. Managing risk is vital to every investor and there are tools designed to simplify the process. Even so, you as an investor must seek well-qualified counsel. That search, too, can involve considerable effort, but a good decision can make management of your retirement funds more effective...and less complicated.