

July 2009 *MoneyMinute* – “VIP” Stocks go M-I-A

Many of you have read about how Warren Buffett invests – buying a limited number of companies and watching them very closely. Occasionally you will see an article about investing in a few stocks is a better way to invest than by being widely diversified.

A recent article from Dimensional Funds Advisors mentions a study done by a magazine in Australia that looked at the issue.

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One of the great myths of the investment world is that you can build a successful long-term strategy around a carefully chosen small number of stocks that are perceived as generating good earnings growth year after year.

Just why this myth refuses to die may be a testament to the power of hope over experience. But it's useful now and then to see the dire results of concentrated portfolios, even those chosen by supposed experts.

In mid-2007, the Australian Financial Review's Smart Investor magazine published a front cover story called 'VIP Stocks — 25 Companies that Grow Earnings Year after Year'.¹ The 'VIP' tag in this case stood for 'Very Impressive Performers' and was accompanied by a rather nifty photograph of what looked like a backstage pass.

The implication was that this was the portfolio favoured by insiders. The blue ribbon stocks were chosen after analysts "pored through consensus earnings forecasts for Australia's top 500 listed companies" to find the 25 that they agreed had the best potential in terms of earnings per share (EPS) growth.

This was a detailed and rigorous process, we were told. To ensure the chosen stocks were not "just a flash in the pan", the magazine's analysts insisted on a superlative track record. The companies had to have had at least double-digit EPS growth in both the 2005 and 2006 financial years, as well as "a top earnings outlook" for either 2007 or 2008.

To ensure the companies were generating earnings efficiently, the analysts required that each stock had a return on equity of at least 12 per cent. And to cover the risk that all the good news was priced in, they excluded any company with a price-earnings ratio "wildly above" the industry average.

So given these high hurdles, it would seem reasonable to expect that Australia's top analysts would create a small portfolio that would shoot the lights out, or at least outperform the market, wouldn't you think?

Unfortunately not. Of the 25 "very impressive performers" for 2008, only a mere seven (or less than a third) ended up performing better than the market, as defined by the S&P/ASX-300 Accumulation Index. They were Sonic Healthcare, Computershare, TechnologyOne, IBA Health, Iress Market Technology, Beach Petroleum and JB Hi-Fi.

On the flipside, 18 of the 25 underperformed the market. And of those, 12 lost 60 per cent or more of their value. In fact, the two worst performers in the magazine's list of "VIP" stocks went missing in action altogether. Investment companies Allco Finance Group and Babcock & Brown imploded over 2008 and now are no longer listed.

Overall, if you had decided to put your own money into this concentrated, "rigorously analysed" portfolio of Australian stocks last year, you would have generated an average return of a negative 58.58 per cent, against a negative 38.90 per cent return just by owning the market. And this is even before taking brokerage costs into account.

It should be clear from this that when you hold such a concentrated portfolio you are taking on unnecessary risk. You expose yourself to stock specific and industry factors that can blow your portfolio out of the water.

The fact is it doesn't matter how well those individual stocks have performed up until that point. More often than not, their superlative past performance is recognised by the market and is reflected in prices.

When it comes down to it, investment is about what happens next. We don't know what happens next. And that's why we diversify.

(Jim Parker would like to thank Rob Brown for his assistance with this article)

¹'VIP Stocks', *Financial Review Smart Investor*, June 2007

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