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Don't Play "Concentration"

The explosive growth in the mutual fund industry has led both to tremendous opportunity and severe dangers for investors. The opportunity is a wealth of funds (almost 7,000 in the database we use) to choose from. A danger is that fund managers may so concentrate fund assets in a particular industry that fund investors lose the benefits of diversification. This is especially dangerous if the investors do not realize how concentrated their fund portfolio is.

Sigma recently completed a study of industry concentrations among the 1,761 U.S. equity funds in our database that were not openly specializing in a particular industry or sector. The benchmark Standard and Poor's 500 average has about 8.8 percent of its market capitalization in technology companies. Our universe of non-specialized U.S. equity funds had an average portfolio concentration of 16.4 percent in the technology sector, an 86 percent greater technology commitment than the S&P 500 average. Two-thirds of these funds had technology weightings greater than the S&P 500.

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Whatever you think about technology investments, we believe many mutual fund investors do not realize the substantial "bet" they have unknowingly been making on tech stocks. While investors in technology specialty funds have deliberately chosen to emphasize that industry in their portfolio, the bulk of investors in "growth" mutual funds probably have not made such a conscious choice. Yet the 415 "growth" funds in our universe have an 18.5 percent technology weighting, almost a fifth of the total fund portfolio and almost twice the S&P 500 weighting. The 336 mutual funds in the "small company" category have a 23.0 percent technology weighting, while the 78 "aggressive growth" funds have a 30.0 percent tech weighting (more than triple the S&P 500). These funds all have generic names that would not tip you off to their emphasis on the technology industry.

These fund groupings indicate that general U.S. equity managers have steered their investments towards technology more than you might realize. The story becomes more alarming, however, when you look at individual funds. In our universe of general U.S. equity funds, 566 funds had a technology weighting that was more than double that of the S&P 500, while 314 funds had a tech stock allocation more than triple the S&P 500. 32 mutual funds had more than half their assets in technology stocks. Our personal favorite was a mutual fund (sponsored by a stock brokerage firm) in the "balanced fund" category (which indicates a balance between stocks and bonds) that held no bonds, a leveraged commitment to equities of more than 100 percent of assets, and a 56 percent technology weighting. Remember, these are general equity funds, not specialty

technology funds. One fund, Reserve Informed Investors, has a 94 percent weighting in technology -- we hope their investors are indeed "informed" of this extreme concentration.

One "balanced" fund had a 56 percent technology weighting. One growth fund had a 94 percent technology weighting.

We have no ax to grind on technology stocks -- they are just the most recent example of how Wall Street can fall in love with a sector and concentrate investments in a volatile industry. Last

August, we were quoted in the newspaper likening the technology sector to a wonderful party that was about to end. By mid-January, semiconductor stocks fell 36 percent and other technology indices also declined substantially. (OK, we do have something of an ax to grind.) Similar mutual fund concentrations were seen in oil stocks in the late 1970's, biotech stocks in the late 1980's, etc.

There are two lessons from this:

1. You cannot throw money into a mutual fund and assume that you are diversified. Generic names like "Reserve Informed Investors" can mask an extreme commitment to one narrow sector of the market.

2. You should not choose funds for your portfolio based on the winners of the ubiquitous "performance sweepstakes" in the popular press. The way to win a short term performance contest is to concentrate bets in one volatile industry -- if it does well, you win. This is no way to invest for your retirement. The best performing funds over a short measurement period tend to be those funds making specific, narrow bets. The winning bets for one period are unlikely to be as good in the next period -- just ask last summer's investors in semiconductor stocks.

So what should you do? If you are interested in learning more about your mutual fund's allocation to specific industry sectors, give Sigma a call. We will be happy to run an industry concentration "check-up" for you, listing the percentage allocations and comparing your fund's sector breakdown to the S&P 500.

Data Source: Morningstar OnDisc, January 1996