Diversification Deceit

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If you ask a typical plan participant what their single largest retirement asset is they will probably think for a moment and then provide you with a list of assets ranked by their perceived value in descending order. They might include their defined benefit plan, their 401(k), perhaps a home, then work their way down to less valuable, frequently less liquid assets. Somewhat surprisingly, the single largest asset, the asset that can most meaningfully impact the level of their wealth in retirement - short of inheritance - is usually left off the list completely. The net present value of a participant's income right up until the moment they retire is this critical component of retirement wealth. The greater the number of years between now and their retirement date, the more relevant this unsung asset will be. Broadly speaking, for people less than 50 years of age, this asset dominates their wealth. Such an overlooked reality creates an unintended and potentially costly investment overweight in the industry where an individual spends their career.

In this era of specialization in the workforce, plan sponsors, consultants, and the individuals themselves need to consider their industry concentration level within the context of their entire portfolio. In spite of the fact that the number of jobs that employees will have by the time they reach retirement is rising, most of these jobs will nevertheless be in the same industry. This specialization introduces specific risk to the portfolio as an individual's ability to earn wages will rise and fall with the economic viability of their particular industry.

Exasperating this issue is the growing component of 'non-cash' compensation for employees. In addition to obtaining industry exposure through cash compensation, older and more experienced employees are increasingly paid a higher percentage of their total compensation in stock and options, thereby increasing their industry exposure even further. This means that precisely at the time employees should be shifting away from equity and toward a less risky asset class like fixed income, they are being given (and are usually required to hold for a period of time) even more industry specific risk via stock and options from their employers.

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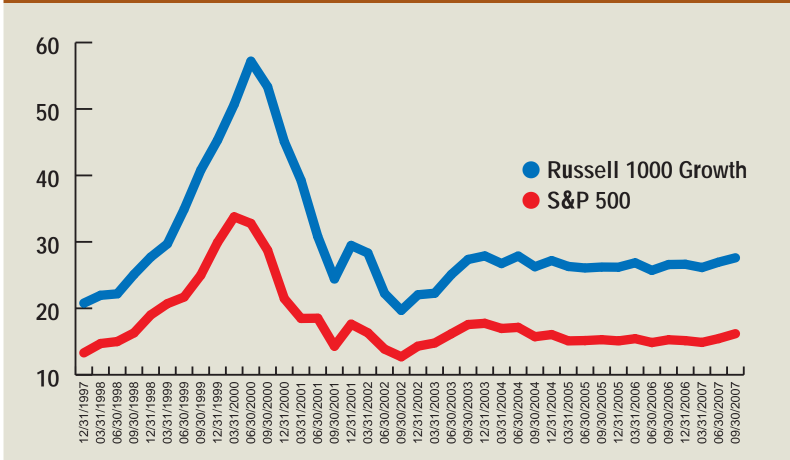
Many employees are also individual investors and, in that role, they bring more industry specific risk to their personal portfolios. The growth of the defined contribution market, where employees manage their own investment process and where they have relatively easy access to trading, has introduced another means by which employees inadvertently increase their exposure to the industry where they work. Many employees are most comfortable buying stock in companies that produce goods and services they have a high level of familiarity with. Their expertise in the industry they work in generally means they are likely buying securities that ultimately compound their lack of diversification.

To illustrate how pervasive this issue can quickly become, envision a young employee in the technology sector who is attempting to build a well diversified portfolio for his retirement. During his first few years of employment he is likely to have a very small portfolio of assets to manage and a vast majority of his compensation is probably in the form of cash. As profits in the technology sector increase, so too will his compensation and ability to save. If the technology sector performs poorly, however, his ability to increase his current compensation will be hampered. Extrapolate this correlation between his compensation and the performance of the technology sector over the next 25 years and one can quickly see

Chart 1: Technology Sector Weightings, Past 10 Years (%)



Source: Frank Russell Co. via Factset Research Systems, Inc. / Quarterly data from 12/31/97 - 09/30/2007 / For complete GICS disclosure see end presentation.

how this young employee's fortune is closely aligned with the industry in which he chooses to work.

Perhaps this young employee recognizes that his ability to earn income and ultimately save for retirement is closely aligned with the technology sector and he decides to diversify that risk through allocating into index funds. On the surface, this appears to be a reasonable solution; however, the broad-based equity indices also have significant weightings in the technology sector, so his diversification benefit is diluted. As Chart 1 demonstrates, the weighting of the technology sector in the S&P 500 has in recent years reached as high as 34 percent and has a ten-year average of 18 percent weighting in the index. Consequently, allocating into broad-based equity funds as a means of obtaining a diversification benefit is suboptimal.

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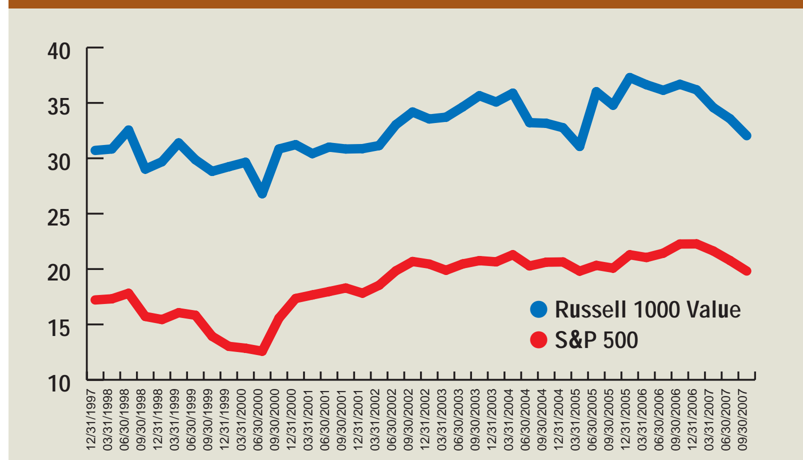
As his career progresses, his ability to buy individual securities is likely to present itself as another means of investing for retirement. Believing that he has an information edge in technology, he builds a portfolio of securities heavily concentrated in the very sector he is already overexposed to. This mistake of not weighing a modest information edge against what amounts to a much more important diversification benefit is a common phenomenon.

During the middle and latter stages of his career, this employee is then likely to receive a higher percentage of his compensation in stock and options. While his employer views this as a strategic decision to align an employee's interests with the performance of a company, it also serves to amplify the industry specific risk in a retirement portfolio.

Clearly, this employee needs to find effective strategies to diversify his inherent exposure to technology. In fact, this diversification dilemma exists for employees in most industries. Foundations and endowments can face the same issues if they have a concentration of contributors from the same industry, as a contributor's ability to donate is aligned with the profit cycle of their industry. Even some public plan sponsors can face similar issues if their tax base is concentrated in a few industries, as their ability to raise taxes to make contributions could rise and fall with the vibrancy of those industries. For example, it could be easily argued that the fortunes of the City of New York and its government sector employees are closely tied to the success of the financial industry (See Chart 2).

Like most problems in finance, it is often easier to grasp a problem than it is to develop a solution. Working closely with plan sponsors and consultants, investment managers can develop solutions that include identifying industries with low correlations to the overexposed one and building portfolios that help mitigate industry concentration. Another approach could be the use of factor-based exchange traded funds (ETFs) where the factors themselves have low correlations. Each industry and, in many cases, each employee faces distinctive risks dependent upon the industry they work in and where they are in their savings life cycle. As a result, managers are continually developing unique solutions with the simple goal of helping investors achieve financial security. ■

Chart 2: Financials Sector Weightings, Past 10 Years (%)



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