In Praise Of Portfolio Simplicity
by Ken Hawkins (Contact Author | Biography)

Many investors find themselves with a portfolio that is too complicated to understand, hard to manage and difficult to change. In fact, some investors' portfolios contain so many mutual fund and principal protected notes (PPN) that they match the complexity of billion dollar pension plans, but without the expertise and resources required to manage them properly. Individual investors, especially those who invest in mutual funds, should strive for simplicity in portfolio construction. Koichi Kawana, a designer of botanical gardens, says "Simplicity means the achievement of maximum effect with minimum means." This could also be applied to an investment portfolio.

Factors Adding Complexity

Some of the factors contributing to a portfolio's overall complexity include:

Too Many Advisors

It is not unusual for some investors to have two or more investment advisors as well as managing part of the overall portfolio themselves. The belief that two heads are better than one and that each advisor can provide a different perspective with different investing ideas results in multi-advisor accounts. Without an overall investment strategy to provide the necessary discipline, having more than one advisor might just complicate the portfolio without adding to performance or contributing to risk reduction. This is especially the case if the advisors have the same investment mandate. (For related reading, see Choosing An Advisor: Wall Street Vs Main Street and Do You Need A Financial Advisor?)

Too Many Accounts

Without much difficulty a husband and wife can have several investment accounts. If each spouse has an IRA, a 401(k), a taxable investment account and a joint account between them, there is a minimum of seven investment accounts. If some of them are split between different institutions as well as managed by themselves it is not unusual for the household to end up with more than a dozen different accounts. Every account at a different institution will have a different reporting standard, which adds to the complexity. Monitoring your investments and determining what investments are put in each account only adds to the administrative burden.

Too Many Securities

Each individual security in a portfolio requires some attention. There is a mistaken belief by some investors that if one mutual fund is good then five must be better. The goal should be to attain proper diversification with a minimum number of securities, rather than adding more. (For related reading, see The Dangers Of Over-Diversification)

Investment Products Are Too Complicated

A simple mutual fund investing in one asset class, such as large cap equity, fixed income, global equities etc. is relatively straightforward. A balanced fund that invests across several asset classes or a fund of funds adds another level of complexity. Many products, such as hedge funds and PPNs with their embedded insurance contracts are very difficult to understand by themselves. The tools and expertise required to effectively understand and manage the risks associated with many of these products is often beyond the reach of the individual investor.

Complex Portfolio Problems

A good balanced fund, especially one that is balanced internationally, may be a good choice if your portfolio has just one or two funds, but a portfolio containing six to 10 balanced funds seldom makes a for a good investment. This is because these additional funds just add complexity without further reducing risk or enhancing performance. Diversification to a point is always a desirable attribute, but over-diversification should be avoided. Portfolios that are over-diversified with too many mutual funds will almost always under perform after the fees are deducted.

To be confident you are making a correct investment decision, it is important to consider the characteristics of an individual security, and the potential impact on the overall portfolio. Will the purchase of the security reduce the overall risk by providing additional diversification or will it increase risk by increasing the concentration in one security or one sector of the market? As markets change, many potential opportunities present themselves, but risk and volatility may also increase. Making the proper investment decisions becomes more difficult and confidence is
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http://www.investopedia.com/articles/basics/08/simplify-investing.asp?

eroded as the complexity of a portfolio rises. (To learn about risk management, read Measuring And Managing Investment Risk.)

Simplify
One of the first steps to simplifying your portfolio is to consolidate as many investment accounts as possible. How the investments are allocated to the different accounts can not only improve the portfolio's simplicity, but can also make it more tax efficient as well. Although it is important to have an overall objective and asset mix for the consolidated portfolio, it is not important that each account have the same objectives or asset mix.

Each account whether, it is a tax-deferred account or a taxable account, can have a very specific objective and type of investment. One account may be mostly fixed income and another might be more trading orientated, while yet another is just for global investing. Consolidating will not only make it easier to understand and monitor these accounts, but it might help make them more tax efficient as well.

An easy way of simplifying a portfolio is to reduce the number of positions, either mutual funds or individual securities. There are often small insignificant holdings that will have very little impact on the overall portfolio if they are sold. Individual stocks that represent less than 2% of the total equity asset allocation can often be eliminated without impacting performance or diversification. Similarly for mutual funds, broad based mutual funds that represent less than 5% of the overall portfolio could be eliminated. Holding a balanced mutual fund in a portfolio that is already balanced makes little sense, it only complicates matters, but holding mutual funds that invest in single asset classes accomplishes makes a portfolio easier to understand at a glance and easier to locate in the account.

With an account that holds many mutual funds, there are likely to be funds that are similar in style and performance. Eliminating some of the funds and putting the proceeds in the best of the existing funds will simplify the portfolio and improve the probability of creating an outperforming portfolio without hurting diversification.

A portfolio containing index funds or some broadly based exchange-traded funds (ETF) is simpler than actively managed mutual funds or an actively managed portfolio of individual securities. An investor does not have to be concerned with the active management of the assets, only with the asset mix. Replacing three or four mutual funds that invest in U.S. stocks with an appropriate ETF will not only simplify the portfolio, but improve its underlying performance as well. (For more insight on management, read Words From The Wise On Active Management.)

Conclusion
In investing, it is often better to keep things simple. Simplifying your portfolio will make it easier to understand, manage and in the long run this should improve its overall performance. After all, with a simpler, less complicated portfolio, the investor will be able to focus his or her efforts on improving its performance, rather than trying to sort out how it works.

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