The Advantages of the Do-It-Yourself Approach to Investing in Stocks

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With the right education and information, individual investors are fully capable of becoming effective managers of their own assets. If you have the time, interest and discipline, we truly believe that you can manage a stock portfolio that can outperform most mutual funds.

Some investors should use mutual funds and ETFs to invest in equities. Those without the time to manage a stock portfolio should stick with funds. (Depending on your investment strategy, however, it doesn't take much more time to select stocks than it does to build a portfolio of funds. The approach behind AAII's **Model Shadow Stock Portfolio** relies on a review just once per quarter.)

The major reason not to manage your own stock portfolio is if you cannot generate the discipline to follow a program once you have committed to one. Many approaches to investing can be successful, but failure to identify a sound approach and follow it religiously will lead to disaster.

Additionally, investors starting out with less than $15,000 should first invest through funds in order to diversify and avoid high commissions as a percentage of the amount invested. You should always maintain a diversified portfolio with no fewer than 10 stocks. If you don't have a diversified portfolio, you are taking on risk that can be avoided and are not be being compensated for that risk. You are actually better off with 10 growth stocks than one blue-chip stock.

The Case for Do-It-Yourself

Individuals have tremendous advantages over institutions. Individuals have the flexibility to hold as many or few stocks as they see fit. There are many cultural, social, operational and legal constraints that restrict institutional investors, impact the timing of their transactions and impact the stocks they own. Funds often have to sell stock positions at inopportune moments to meet redemption demands, even if stock prices are falling and bargains can be found. Individuals have much greater control over when to buy or sell their positions.

Individual investors can also move quickly without impacting the underlying bid/ask spread (the difference between the price at which you can sell the stock and the price at which you can buy the stock). Institutions are concerned about liquidity—the ability to buy and sell stocks quickly without distorting the prices—so they tend to gravitate to larger stocks that everyone else owns. Individual investors can select from over 6,000 domestically traded stocks. Most institutions are limited to the largest 1,000 to 2,000 companies, but the best long-term returns have come from investing in micro-cap stocks outside that range.

Diversified funds cannot own more than 10% of the shares of a given company or more than 5% of fund assets in a given investment. As a result, the biggest funds are further forced to limit themselves to the largest 100 to 200 companies. A diversified mutual fund with $1 billion in assets under management needs to invest in at least 20 stocks (to comply with the no-more-than-5%-of-assets rule) resulting in an average of a $50 million investment in each company. Since a fund cannot also own more than 10% of the shares of any given company, a large fund cannot effectively invest in smaller companies. For our billion-dollar fund example, each of the 20 companies would need a market capitalization (shares outstanding times market price) of at least half a billion dollars (10% of $500 million equals $50 million). The bigger the equity fund, the harder it becomes to outperform the competition, as you are forced to concentrate holdings among the largest companies.

Another important advantage of managing your own portfolio is the ability to time trades to provide tax benefits. Most mutual funds are focused on pretax returns and may saddle their investors with a substantial annual capital gains tax bill, even if they have not held the fund for long or sold any of its shares. Mutual funds must distribute realized gains and interest or dividend income to their shareholders every calendar year. If you hold shares in a taxable account, you are required to pay taxes on mutual fund distributions, whether the distributions are paid out in cash or reinvested in additional shares. If you manage your own portfolio, you control which stocks are sold and when. You can even look at your holdings at the end of the year and do some selective tax-loss harvesting.

The average mutual fund expense ratio is a 1.25% annual drag on portfolio performance; more if you include load funds. With deep discount brokerage commissions, you can keep that annual 1% to 2%

fee you are paying someone else in a mutual fund. It may not sound like much at first, but over the long term even small increases in your realized rate of return will have a big impact on your wealth thanks to compounding.

If you are still in doubt, consider an experiment. Continue to use mutual funds, but invest part of your equity assets yourself and compare the results. Just keep in mind that to do the comparison properly, you must manage a diversified portfolio using a disciplined approach and not just occasionally buy or sell stock based on a hot tip or when the mood strikes you. We strongly suggest that you keep a written record of your investments. Every time you buy a stock, write down why it was purchased as well as any conditions that would make you sell it.

Related:

- The AAII **Model Shadow Stock Portfolio**
- **AAII Stock Screens 2015 Review**