LIFE UNLOCKED
PARTNERS™

Why Does My Portfolio Include "Losers"?

Introduction

Good portfolios include stocks that, by themselves, look like losers at any given time. In truth, these "losers" form an important part of a well-balanced portfolio for investors targeting lower risk returns that keep close to the overall economy. How does that make any sense in a rational world?

When we diversify the types of stocks we hold in any portfolio, we **should experience far lower volatility** for a similar annual return when compared to a group of stocks that move alike. That also means as some things go up, others must go down despite these businesses still producing solid profits (Reminder – volatility is the combination of a company's business risk plus how stock traders speculate about its future.)

We target that lower volatility for our client returns by heeding advice from Nobel-Prize-winning Economist Harry Markowitz – "diversification is the only free lunch in investing."

Diversified Portfolio Design – How It Works

Let's imagine a very simple world with just four companies. Each makes a variety of dwarf statues for people's lawns – we'll call them Jumpy, Slumpy, Grumpy and Bumpy.

The following table illustrates how each dwarf manufacturer performs over the three types of year we can experience:

Company	Avg Yr. Price Change	Off Year Price Change	Big Year Price Change	Odds this is an Average Year	Odds this is an Off Year	Odds this is a Big Year
Jumpy	50%	-50%	100%	35%	40%	25%
Slumpy	-3%	25%	-2%	40%	30%	30%
Grumpy	5%	3%	12%	80%	10%	10%
Bumpy	25%	-15%	35%	20%	40%	40%

Jumpy is the most volatile/risky stock. Think of an NVIDIA that moves at least 60% in any year and the odds favor a big upside each year.

Slumpy tends to go down, is not very volatile, occasionally has a good year, and it looks like a real loser. Think of a company who has fallen on hard times but is not going out of business – like 3M.

Grumpy is the least volatile, always ekes out a reasonable profit and typically returns 5.5% every year, like a high-grade bond.

Bumpy is Jumpy's less volatile younger brother. It performs like Hewlett Packard – a mature but still volatile tech stock.

If I am just picking stocks to own and I'm conservative, give me Grumpy all day long. Looks like the best bet if we do not want to risk our capital, but is it the best overall stock to hold and can I keep pace with the overall market that way?

To figure this out, we need to calculate the average expected return from this world based on the odds of any kind of year happening. For Jumpy, the calculation is 50% x 35% (Average year returns) plus -50% x 40% (Off year returns) plus 100% x 25% (Big year returns) which equals an overall 22.5% expected annual return with very high volatility at 62%!

Please find below the table for the expected annual return and volatility when we do not know what kind of year we will have, or what it's like to buy any stock today because we are buying future performance, not past:

Stock	Expected Annual Return	Annual Volatility
Jumpy	22.5%	62%
Slumpy	2.2%	8%
Grumpy	5.5%	2%
Bumpy	13%	23%

Now, looking at our dwarf companies again we can see that owning Jumpy will get you whopping returns more than half the time, but it can dive, too. It has the highest volatility and about double the expected return from Bumpy who also experiences a lot less volatility. While Bumpy's volatility weighs in at 23%, is that good? If I told you the overall stock market volatility in 2024 is closer to 18%, we would then conclude that Bumpy is riskier than average. Finally, Grumpy and Slumpy have much lower volatility and only Grumpy looks like something I would want in a portfolio.

If I can only own one stock, I probably choose between Grumpy and Bumpy based on our very simple world, but is that the best answer? Could it be better to hold both Grumpy and Bumpy, or maybe own every stock? Let's find out.

Portfolio Math Simplified

I already like what Grumpy and Bumpy offer me in a world with only four stocks, but would owning both be best? What about adding Slumpy to the mix or even buying all four stocks equally?

When we look at the three types of years we might experience (Average, Off and Big), our stocks give very different returns in each scenario. Slumpy does well in an Off year and Jumpy does super well in a Big year. If we do not have those stocks in our portfolio when Off or Big years hit, would we miss too much?

Portfolio math can provide answers by looking at how each of the four stocks perform on their own, **and** how they move in relation to each other. After performing all those calculations, we get the following portfolios, their expected returns and their volatility/risk results:

Portfolio	Portfolio Holdings*	Expected Return	Expected Volatility/Risk
Port1	Grumpy/Bumpy	9.25%	10.0%
Port2	Slumpy/Grumpy/Bumpy	8.07%	7.3%
Port3	Jumpy/Slumpy/Grumpy/Bumpy	11.68%	21.1%

*Each Portfolio holds an equal amount of each stock.

Let's start with **Port3** giving us the highest expected return and volatility. In other words, we expect anything from 14% to 9.2% about two thirds of the time. About a third of the time, **Port3** experiences even more extreme results, including years where it loses money.

Port2 has the lowest returns and the least volatility where we expect anywhere from 8.7% to 7.5% returns each year because Slumpy and Grumpy have the lowest volatility among our stocks. In other words, with **Port3** having the larger spread in returns, there are years where these perform closely or years where **Port2** wins.

Finally, **Port1** offers something in the middle.

Note: we could build a few more portfolios, for example, a Jumpy/Grumpy/Bumpy portfolio that has about the same 22% volatility with about 2 percentage points higher expected returns than **Port3**. The differences are not enough that we have to explore them to illustrate our point. If we were actually buying, though, we would examine every version.

Analysis

If you like risk and do not mind returns changing 50% on average (14% is 52% higher than 9.2%) with even more extreme results in some years, then **Port3** is for you. Of course, it comes with very high volatility and can even lose money.

If you need more predictable performance, then **Port2** offers the tightest range at about 16% from the highest to lowest returns in most years while keeping in touch with the economy.

Finally, **Port1** offers something between the two, but we have to take almost 50% more risk than owning **Port2** for only about 1.2% extra return each year. So, which is the best portfolio?

Conclusions

To succeed, we want to find the best trade-off between volatility/risk and returns that keeps us closest to the overall economy.

The best portfolio for most Life UnLocked clients would be **Port2** with Slumpy even though it looks like a loser; and that requires some explanation because you would never buy Slumpy just for its expected 2.2% return each year. The secret is that as bad as Slumpy is, it moves up when the other stocks move down and that provides very valuable stability in off years – a defensive shield for our portfolio.

In other words, the effect of adding Slumpy to our Grumpy/Bumpy portfolio lowered our expected return by 13% while also reducing our volatility/risk by 30% - that's a trade-off I might take if stability while keeping close to the overall economy is my goal.

Remember, our entire economy consists of the four stocks with their combined expected return of 11.68% each year and 21% volatility. If I only own Grumpy, I take almost no risk and I fall more than 50% behind the market every year (5.5% return versus 11.68%.) That would be a terrible underperformance that many very conservative investors still choose over a portfolio that provides much better upside for taking a little more risk.

Port2 gets me a lot closer to 11.68% while taking 67% less risk. If my goal is to keep close to the economy while managing down risk, my portfolio must take additional risk in such a way that it adds return without taking on as much risk. **Port2** accomplishes that task for more conservative investors.

If you like a little more risk, **Port1** still provides good trade-offs by taking a bit more risk (half of the 21% total market volatility of holding every stock) to get within almost 2.5 percentage points of the overall economy. That's a really good trade off where a bit more risk is desirable, but it lacks any defensive shield for a down market.

We hope it's clear the best portfolio is neither owning a single stock nor everything. Further, by combining stocks that move differently across different environments, we can create risk/return trade-offs that fit our lives and risk tolerance through balanced defensive and aggressive stock holdings.

The average Life UnLocked client is somewhere between taking reasonable to lower risks so we cannot swing for grand slam home runs without violating boundaries. In other words, losing a big chunk of capital would be a disaster from which many of our clients would struggle to recover, including me. When we bear that level of responsibility for client preservation, we must guide our risk taking toward a **Port2** style portfolio that includes defensive positions to protect from the world having a really bad year.

If your brain has not melted, congratulations – you're ahead of the average investor.