LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> Man should always divide his wealth into three parts: one-third in land, one-third in commerce, and one-third retained in his own hands.
>
> –Babylonian Talmud

Diversification is an important aspect of any sound investment program. While diversification may encompass several types of assets as suggested above, the focus of this discussion will be restricted to financial assets and portfolio construction.

A portfolio is quite different from the sum of its parts. Much as an alloy formed from two or more metals has characteristics different from each individual metal, a diversified portfolio has characteristics different from the individual securities that make up the portfolio. Copper and tin when melted together from bronze which is harder than either copper or tin. An individual security is quite risky. But when individual securities are combined in a portfolio of securities, the portfolio is stronger and risk is reduced. That is because when one security does worse than expected, another may do better than expected.

Diversification is more than just a conglomeration of many different securities. To begin with, consider the differences between bonds, stocks, and cash equivalents. Each category has special characteristics and deserves a place in most portfolios. Bonds are contracts to pay specific amounts (interest) on a regular basis and to pay principal back at a specific time (maturity). Stocks share in the profits of a company and can rise and fall as the company's business prospers or fails. Cash equivalents are great for paying current bills or buying bargains but their income can have wide swings as short-term interest rates change.

It is not enough to say some of each: bonds, stocks, and cash. It should not be all 30-year bonds or all electric utility bonds. Nor would ten different chemical company stocks be as sound a diversification as ten good stocks in ten different industries. Stock portfolios should have a pattern of spaced development (see our April, 1990, "As We See It"--*"The Greenhouse Effect"*) just as bond portfolios should incorporate a "laddered" maturity schedule. A portfolio is stronger if its holding have different life cycles and expected payoff periods.

There is no infallible way to achieve sound diversification. We believe it is best achieved as a by-product of developing a wide variety of ideas and expressing those ideas via securities in a portfolio. Viewed in this way, the adequacy of the diversification is dependent upon the breadth of knowledge and experience of the portfolio manager. In other words, experience counts.

Sound investment principles are durable. Effective diversification is as important to the preservation of wealth today as it was in ancient Babylon.

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