



FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

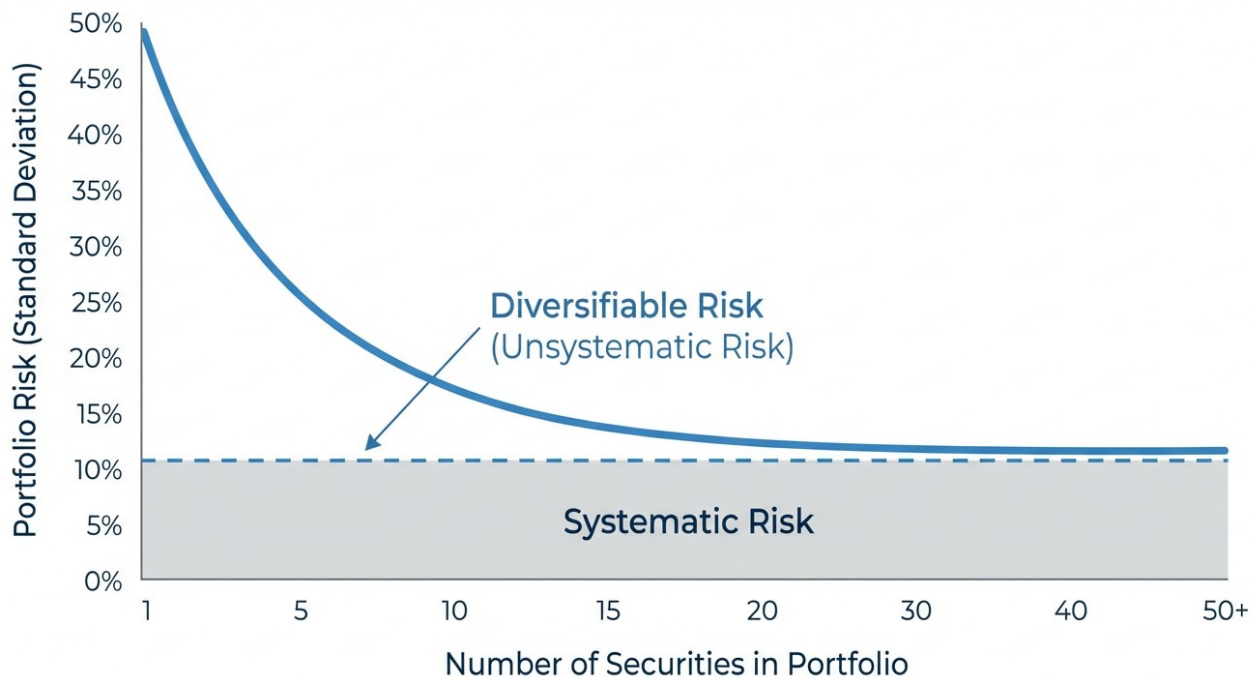
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Diversification

In [last week's issue](#), I mentioned that the only free lunch available to investors is diversification. Investment risk can be categorized as either systematic or unsystematic. Systematic risk (also known as market risk) is the risk that the stock market as a whole will decline. Unsystematic risk is risk that's unique to a company, industry or country. An example that I used to use with my clients in the 1990s: "What if one day, it's determined that drinking Coke causes cancer? What would then happen to the price of Coke stock?" I know, weird theory, but [who could have predicted that?](#)

Fortunately for investors, as the number of randomly selected stocks in a portfolio increases from one, unsystematic risk declines rapidly before tapering off to a *de minimis* amount at around 20 stocks. Since unsystematic risk can be eliminated through diversification, the market doesn't compensate investors for accepting unsystematic risk; it compensates investors (over the long term) only for accepting market (systematic) risk.

The vast majority of investors who have a large exposure to an individual company, industry or country (which doesn't increase their expected return) have never heard of unsystematic risk and have no idea that they are bearing a large amount of risk that could be eliminated through diversification.



The key phrase above is “randomly selected.” So if you own say ten stocks in the AI sector, you haven't reduced your unsystematic risk by much. I don't invest in a random selection of stocks, but the quantitative, value and dividend-driven, bottom-up process that I employ (as opposed to a top-down process that's based themes, [stories](#) and predictions) results in an eclectic collection of stocks in various industries and countries. I'm often surprised by my portfolio's composition, but I just go where my value/dividend muse leads me.

Most American investors today have a large exposure to the S&P 500 index, either because they're trapped in an employer retirement plan that has few investment options (such as a handful of index funds), they believe in the Efficient Market Hypothesis (all markets are always perfectly efficient and there are never any abnormal profit opportunities available), they have [Home Country bias](#), or they're currently chasing returns.

Many of them believe that that index alone provides broad diversification because it consists of 500 stocks. The devil is in the details, however. Like nearly all indices, S&P 500 index funds are weighted by market capitalization (the number of shares outstanding times the current stock price). Currently, the top eight companies in that index (which are all pretty much in the technology industry) [comprise 38.4% of it](#), which is unprecedented. When something has never happened before, it causes my contrarian antennae to perk up, because it usually means the situation is unsustainable.

Yes, investors who own an S&P 500 index fund technically own 500 stocks, though they have much more [concentration risk](#) than they realize. They may assume that owning 500 companies has eliminated unsystematic risk, but it has not due to the very large weighting of the top stocks. If the value of those stocks continue to appreciate relative to the other 492 stocks, these index funds have to buy more and more shares of them, regardless of their current valuation, dividend yield, investor sentiment, insider selling, [short interest](#),

possible financial fraud by management, etc. For this reason, for many years now (ever since I read the book [The Fearful Rise of Markets](#)), I have been saying that market cap-weighted index funds are a Doomsday Machine.

I avoid concentration risk by limiting my weighting in each stock to a maximum of around 1.5%. My target weighting for each stock is determined by a formula that's based on its current fundamentals (which are constantly changing), so most stocks have a target weighting of about 1% or less because there is almost always something about a company that's not attractive. This limitation is a discipline that instills *humility* in my investment process, which is one of the most important values an investor can have.

By way of contrast, investors who own an S&P 500 index fund have 8.3% of their capital in richly valued (price/earnings ratio of 48) NVIDIA. Its current Beneish M-score of -1.34 indicates that management is likely manipulating its reported earnings. If the stock price rises (perhaps as a result of fraudulent accounting), the index fund has to buy more shares. Good luck with that.

In conclusion, I want to point out that owning an eclectic collection of at least 20 (dividend-paying) individual stocks, along with a cash hoard of at least 20%, gives you *optionality* and *freedom of maneuver*. If you have all of your portfolio in an S&P 500 index fund (as many investors do; and many if not most of the stocks in it do not pay a dividend), the only actions you can take is either to buy more of all 500 stocks, hold all 500 stocks, or sell all 500 stocks.

Additionally, your weighting in each of those stocks *is not up to you*, and could rise to a very large percentage *without your knowledge*. Do you think any S&P 500 index funds have sent a letter to their shareholders informing them that 38.4% of their capital is invested in just eight stocks that are all pretty much in the same industry?

If you own a portfolio of individual dividend-paying stocks along with plenty of cash, you're free to buy, hold (and collect decent dividends) or sell any of them or buy some new ones when valuations and investor sentiment are more attractive. As an investor, you never want to be limited to just two options (hold or sell just one holding).

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