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Score: Diversification 1, Coke 0

By: Westin Wellingtion

With last week's income tax filing deadline in mind, the issue of whether or not to sell low-cost-basis shares strikes us as an appropriate topic for discussion.

By coincidence, a recent news item in the *Wall Street Journal* offers one striking example of the potential benefits of diversification. The article reported that the recently introduced Coke Zero soft drink has been a "surprise hit" and could be a harbinger of better times to come for weary Coke investors who have watched the share price stagnate for over ten years.

Long-time shareholders with a negligible cost basis are often reluctant to sell for emotional reasons and even more resistant to the idea of incurring a tax liability to do so. In early 1997, an advisor seeking to persuade a Coke shareholder with zero basis to sell her shares, pay the tax, and diversify would likely have faced a difficult challenge:

- At year-end 1996, Coca-Cola shares sold for $52.63, had the highest possible A+ ranking for earnings and dividends from Standard & Poor's, and had paid cash dividends every year since 1893. What blue chip could be bluer?
- Annualized total return for Coke shares was 23.1% for the five year period ending December 31, 1996 compared to 15.22% for the S&P 500® Index. Who needs diversification?
- Berkshire Hathaway, Inc. reported owning 200 million Coke shares as of year-end 1996, and Berkshire CEO Warren Buffett observed in his 1996 chairman's letter that Coca-Cola would dominate its field "for an investment lifetime." If he's not selling, why should anyone else?

Imagine for a moment the advisor was successful in persuading his client to sell her $1 million zero-basis position in Coke at year-end 1996, pay $200,000 in capital gains tax, and reinvest the $800,000 proceeds in a globally diversified equity strategy. The client reviews the portfolio every six months thereafter with her advisor, and the meetings become increasingly contentious as she compares the results of her new portfolio to the value of Coke shares she no longer owns.

Growth of $1 Million

Global equity strategy reflects deduction of $200,000 capital gains tax liability.

	Coca-Cola	Global Equity Strategy	Client reaction
June 1997	$1,292,039	$903,840	Concerned and sceptical.
December 1997	$1,267,148	$908,400	Agitated and impatient.
June 1998	$1,624,549	$997,200	Furious. "You've cost me over $600,000!"

This comparison actually understates the superior performance of the Coca-Cola portfolio over this period since the Coke share value is computed on a price-only basis and does not include cash dividends. An adjustment for dividends would make the comparison even less favourable for the diversified portfolio.

What happens next?

Scenario A: Angry client fires advisor in June 1998, liquidates globally diversified strategy, and re-purchases Coca-Cola shares at $85.50 with the $997,200 in proceeds. She ruefully recalls, "Daddy warned me never to sell Coca-Cola."

Scenario B: Client grudgingly agrees to continue with the global equity strategy.

Over the subsequent nine years, Coca-Cola manages to boost its cash dividend every year, but struggles with declining sales in the US, fractious relations with bottlers, and turmoil in the executive suite. The shares fall over 40% from $85.50 on June 30, 1998 to $48.00 on March 31, 2007. Over this same period, the S&P 500® Index appreciates over 25%. A globally diversified strategy performs very well.

	Scenario A: Coca-Cola Strategy	Scenario B: Global Equity Strategy
March 31, 2007	$598,320	$2,738,160

Global Equity Strategy is the DFA Equity Balanced Strategy as published in the Returns Program. It is a blend of Dimensional US mutual funds with the following weights: April 1998-present: 20% Enhanced US Large Company Portfolio, 20% US Large Cap Value Portfolio, 10% US Micro Cap Portfolio, 10% US Small Cap Value Portfolio, 10% Real Estate Securities Portfolio, 10% International Value Portfolio, 5% International Small Company Portfolio, 5% International Small Cap Value Portfolio, 3% Emerging Markets Portfolio, 3% Emerging Markets Value Portfolio, and 4% Emerging Markets Small Portfolio. Prior to April 1998, Emerging Markets Value was equally allocated to Emerging Markets Small and Emerging Markets. Prior to March 1998, Emerging Markets Small was allocated to Emerging Markets. Prior to October 1996, International Small Company was allocated as 1.75% Japanese Small Company Portfolio, 1.75% Continental Small Company Portfolio, 0.75% Asia Pacific Small Company Portfolio, and 0.75% UK Small Company Portfolio. Prior to August 1996, Enhanced US was allocated to US Large Company. The performance of the Global Equity Strategy allocation mix was achieved with the benefit of hindsight. The model allocation does not represent an actual investment strategy and is provided for informational purposes only. There are limitations in model allocations. In particular, performance may not reflect the impact that economic and market factors may have had on the advisor's decision making if the advisor were managing actual client money. Past performance is no guarantee of future results.

And what if the client had held her original Coca-Cola shares undisturbed through March 2007? The $1 million portfolio at year-end 1996 slumped to $912,027 by March 2007 on a price-only basis, and with dividends reinvested grew to $1,084,988. A pay-the-tax-and-diversify strategy grew to over $1.8 million in the S&P 500® Index and over $2.7 million in the global equity strategy. Moreover, since the cost basis for the global strategy is $800,000 rather than zero, even if the Coke shares had managed to keep pace with the alternative in this example, the client would be better off with the diversified strategy due to the reduced potential tax liability.

Although the outcome favoured the sell-and-diversify strategy in this case, investors cannot be assured of a similar result with other stocks or different time periods. But the history of corporate America offers many examples of prosperous firms that once dominated their industries but struggled (or failed) to adjust to changing tastes, technology or new competitors. Eastman Kodak, General Motors, K-mart, IBM, Pan Am, Sears Roebuck, Pennsylvania Railroad, Polaroid, RCA, and US Steel are a few that come to mind. More recent examples from the global technology and telecommunications boom and bust are too numerous to mention. In a free-market economy, no company is safe from attack by hungry competitors. Diversification puts powerful economic forces to work as an ally, not an adversary.

Fixating on the potential tax liability associated with a low-basis stock is like looking at the hole instead of the doughnut. The focus should be on tomorrow's after-tax wealth, not today's tax liability. A more sensible approach is to compare the expected return for

Company A with that of Diversified Portfolio B. To favor the concentrated strategy, investors must have unusual confidence in their ability to predict the future.

Berkshire Hathaway, Inc. *1996 Annual Report.* Chairman's letter, www.berkshirehathaway.com.

Mckay, Betsy. "Zero is Coke's New Hero." *Wall Street Journal*, April 17, 2007.

Securities data provided by Bloomberg. Standard & Poor's. *Stock Guide*. January 1997, July 1997, January 1998, and July 1998.