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Why do Investors Love Large U.S. Stocks?

By Gil Hanoch, June, 2010

Investors in the U.S. typically have a strong bias towards buying Large U.S. Stocks. This article discusses some reasons for this bias, with their benefits and costs.

Here are some reasons for buying Large U.S. Growth (high price to book value) stocks:

- **Low Risk.** This group of companies is the most stable in the world. They are located in the most developed country in the world, and have very large markets to their products and services. If you were to pick a single stock to invest in, a Large U.S. stock would be a conservative choice, relative to other stocks.
- **Home Bias.** Investors feel comfortable investing in companies geographically closer to them.
- **Familiarity Bias.** Investors feel comfortable investing in names they hear often. Historically this made more sense, when information traveled slowly, and for people who analyzed individual stocks.
- **Costs.** It is cheapest to buy these stocks, in terms of bid-ask spread. This trading cost can reach several percent of the stock price, and historically was even higher, making it a big factor to consider when trading frequently.
- **Tradition Bias.** Investors are afraid of change. Some of the reasons listed above were good reasons for people to buy these stocks in the past. People feel comfortable sticking to approaches that worked in the past, even if they are no longer the correct ones.

As explained above, Large U.S. stocks made sense at times when trades were very expensive, and there were no options to cheaply invest in highly diversified portfolios, with very low turnover¹. Today, assuming you are not a speculator that happened to believe in a certain Large U.S. stock, there is only one reason to invest in such stocks: diversification.

The group of Large U.S. stocks is the least volatile, and has less than perfect correlation with other groups of stocks. These characteristics make it a good addition to a portfolio to reduce its volatility. Given that the returns of this group are the worst of all groups of stocks, in some cases by a wide margin, it makes sense to limit the allocation to this group. Greater allocations should be made to small stocks, international stocks and emerging markets stocks. It may feel riskier to limit the allocation to the safest stock class, but it is not. A highly diversified portfolio of large and small stocks around the world is a lot less volatile than a portfolio concentrated in Large U.S. stocks. See "Can the S&P 500 be dangerous?" (Hanoch, Apr. 2005) for a demonstration of this concept.

Summary

There are many reasons for investors to love Large U.S. stocks, and almost none of them makes financial sense for a conservative investor. The one good reason to hold such stocks is to diversify a global stock portfolio.

¹ Turnover = the percent of the portfolio that is being sold each year. Low turnover means low trading costs. Mutual funds that represent a wide asset class with no market timing or individual stock selection tend to have very low turnover.

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