Dimensional

PERSPECTIVES

The Stock Market vs. Stocks in the Market

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May 08, 2023

The collapse of First Republic Bank is a harsh reminder that any stock can go to zero, no matter how established a company is, or how loyal and wealthy its customers are. The failure of what many considered to be a rock-solid regional bank should serve as powerful evidence of the importance of diversification, what I consider to be one of the first principles of investing.

If your wealth is highly concentrated in any one individual stock, take this opportunity to learn an important lesson: While many people think they know more than other investors, none of us knows more than the market.

Many years before he became a Nobel laureate, my friend and mentor Merton Miller used to say, "Diversification is your buddy." Diversification is the practice of spreading investments across a variety of assets. It's a time-tested strategy to mitigate risk. Children learn about it early in life with the phrase "Don't put all your eggs in one basket," but all too often, grown-up investors forget.

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I think it's safe to assume that the total value of the stock market will not go to zero. But the same cannot be said about any individual stock, no matter how promising the future of a company might seem. Why not? Because we cannot predict the future.

The current price of any stock reflects the value of all its future income streams, but it's no guarantee. Some companies fail. Can anyone predict which ones? Fortunately, there's no need to. You can have a positive investment experience without knowing what's going to happen with any individual stock because of diversification. In investing, diversification is the closest thing any of us can have to a free lunch.

Nearly all investing horror stories start with a simple fact: Someone took too much risk. In the case of First Republic, management took too much risk. But investors don't have to. Anyone who lost their shirt when FRB stock lost its value had too much invested in it. Everyone who invests in the stock market should prioritize diversification in their portfolio. And it's never been easier to do so, because with mutual funds and ETFs—many of which allow you to invest in a broad range of stocks by buying just one security—you can achieve a high level of diversification with the same number of clicks as buying a single stock.

In my opinion, when you concentrate your wealth in single stocks, you're gambling, not investing. And that's fine, as long as you don't mind losing what you bet. First Republic has been included as part of the S&P 500 index since 2018. On the day JP Morgan Chase announced that it was taking over the troubled bank, how did First Republic's dissolution impact the S&P 500?[1] When the market closed, the index was down 0.039%[2].

Now do you see why diversification is your buddy?

1. "First Republic Bank Is Seized, Sold to JPMorgan in Second-Largest U.S. Bank Failure," *Wall Street Journal*, May 1, 2023.

2. S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Decrease of 0.039% was on May 1, 2023.

RISKS

Investments involve risks. The investment return and principal value of an investment

may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Past performance is not a guarantee of future results. There is no guarantee strategies will be successful. Diversification neither assures a profit nor guarantees against loss in a declining market.

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