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A Guide to Owning Individual Common Stocks

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Introduction

According to Warren Buffet, "Intelligent investing is not complex, though that is far from saying it is easy. What an investor needs is the ability to correctly evaluate selected businesses. To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, 10 and 20 years from now."

A Nation of Stock Traders

But do most investors have the patience and fortitude of a Warren Buffet? The data suggests not. According to the New York Stock Exchange, the average holding period for an individual stock on the NYSE is approximately 8-10 months.

The Evolution of Stock Investing: Why Individual Stock Picking Has Become a Losing Game

As we close out 2024, a remarkable shift has occurred in how Americans approach stock market investing. While a record 62% of American households now own stocks—the highest level since before the 2008 financial crisis—the way they own these investments tells a fascinating and important story[14]. This transformation reflects not just changing investor preferences, but a fundamental recognition that the traditional approach to stock investing may no longer serve individual investors well.

The Changing Landscape of Stock Ownership

Something profound has been happening in American investment behavior over the past several decades. While headlines celebrate record levels of stock market participation, a closer examination reveals a significant shift in how investors choose to own equities. The data paints a clear picture: Americans are increasingly abandoning direct stock ownership in favor of mutual funds and exchange-traded funds (ETFs).

According to the Federal Reserve's most recent Survey of Consumer Finances, direct stock ownership did experience a notable surge during the pandemic years, jumping from 15% of families in 2019 to 21% in 2022—the largest increase on record[1]. However, this recent uptick occurred against a backdrop of long-term decline. Historical data shows that direct stock ownership peaked in the early 2000s at similar levels, and the pandemic-era increase likely reflects unique circumstances rather than a permanent reversal of the underlying trend[19].

The real growth story lies in indirect ownership through mutual funds and ETFs. By 2024, approximately 56% of US households owned mutual funds or other registered investment companies, representing roughly 74 million households and 126.8 million individual investors[5]. This represents a fundamental shift in how Americans build wealth through equity markets. Here's the data from Federal Reserve SCF reports, ICI surveys, and academic studies:

Year	Direct Stock Ownership (%)	Mutual Fund/ETF Ownership (%)
1990	17%	12%
1995	15%	21%
2000	21%	35%
2005	19%	45%
2010	15%	50%
2015	14%	53%
2019	15%	54%
2022	21%	56%
1990	17%	12%
1995	15%	21%

The ETF Revolution

The rise of ETF investing represents one of the most significant developments in modern finance. ETF households tend to be younger, more educated, and in earlier career stages compared to traditional mutual fund investors[2]. Interestingly, 21% of ETF households are under 40, compared to just 15% of mutual fund households[2]. This suggests that younger investors are embracing fund-based diversification as their preferred investment approach.

ETF households also demonstrate sophisticated investing behavior. They're more likely to work with discount brokers (11% vs. 2% for mutual fund households) and show greater comfort with investment technology[2]. Despite being younger, these investors maintain substantial financial assets, with average total assets of nearly $1.7 million and median assets of $930,000[2].

Why 15-30 Doesn't Provide Adequate Diversification

For decades, investment textbooks and financial advisors promoted the idea that owning 30 individual stocks could provide adequate diversification. Where does this magical number come from?

In 1970, Lawrence Fisher and James H. Lorie released "Some studies of Variability of Returns on Investments in Common Stocks" published in the Journal of Business on the "reduction of return scattering" as a result of the number of stocks in a portfolio. They found that a randomly created portfolio of 32 stocks could reduce the distribution by 95%, compared to a portfolio of the entire New York Stock Exchange. From this study came the conventional wisdom that "95% of the benefit of diversification is captured with a 30 stock portfolio." The theory suggested that once you owned stocks across different sectors and industries, additional holdings provided diminishing returns in terms of risk reduction. Unfortunately, the theory was never true, and often had disastrous results in the real world.

The Reduction of Risk Is Not the Same As Increasing Diversification

Previous studies of risk and diversification focused on the 'reduction of risk' by measuring standard deviation. The study was not actually about any improvements in diversification. A more recent study by Surz & Price addressed the shortcomings of this approach by using proper diversification measurements. Specifically, they looked to R-squared which measures diversification as the percent of variance which can be attributed to the market as well as tracking error which measures the variance of portfolio returns versus its benchmark. In practice, a tracking error of 5 means a 60 stock portfolio may only rise 7% in a year when the market is up 12%.

The results of their study, Table 1, clearly show that a portfolio of even 60 stocks captures only 0.86 or 86% of the diversification of the market in question.

Ideal Number of Stocks					
	1	**15**	**30**	**60**	**Entire Market**
Standard Deviation	45.00%	16.50%	15.40%	15.20%	14.50%
R^2	0.00	0.76	0.86	0.86	1.00
Tracking Error	45.0	8.1	6.2	5.3	0.0

Source: Surz & Price, The Truth About Diversification by the Numbers, Journal of Investing, Winter 2000

It is important to remember that even this concept of being 90% diversified with only 60 stocks is only relative to the specific market in question, i.e. U.S. large cap companies. Therefore, when you are building your portfolio, it would take many more stocks to diversify against the entire global market.

The New Diversification Reality

Today, a properly diversified stock portfolio may need exposure to hundreds or even thousands of individual holdings. This level of diversification helps protect against the increasingly unpredictable nature of individual company performance while ensuring participation in the relatively small number of companies that drive overall market returns.

For individual investors, achieving this level of diversification through direct stock ownership presents practical impossibilities. The transaction costs alone would be prohibitive, not to mention the research burden and portfolio management complexity. Even wealthy investors would struggle to maintain meaningful positions in hundreds of companies while keeping up with the constant stream of corporate developments, earnings reports, and strategic changes.

The Harsh Mathematics of Stock Picking

Perhaps no research has been more eye-opening for individual investors than the work conducted by Arizona State University professor Hendrik Bessembinder. His seminal research paper examined the performance of all publicly traded stocks since 1926, and the results should give pause to anyone considering individual stock selection[11].

The numbers are stark and sobering. Of the approximately 26,000 stocks that appeared in the Center for Research in Security Prices (CRSP) database over this nearly century-long period, only 4% outperformed the return of a simple one-month Treasury bill. Let that sink in: 96% of all publicly traded stocks failed to beat the most conservative, risk-free investment available[11].

The concentration of wealth creation is even more striking. Just 86 companies—less than 0.33% of all stocks—provided half of the aggregate wealth creation from the entire stock market. To capture 75% of total wealth creation, investors needed exposure to only 282 companies. The complete picture required ownership of just 983 companies, meaning that over 25,000 stocks contributed nothing to aggregate wealth creation[11].

Other studies show that the odds of corporate survival are dwindling. One study included all 29,688 companies that listed on U.S. stock markets from 1960 to 2009:

- Companies that listed before 1970 had a 92% chance of surviving the next five years, whereas companies that listed from 2000 to 2009 had only a 63% chance.
- 80% of the companies that existed before 1980 are no longer around [21]

The Implication for Individual Investors

These findings fundamentally challenge the notion that individual investors can reliably identify winning stocks. If professional money managers, with their armies of analysts, sophisticated research tools, and institutional resources, struggle to consistently outperform market averages, what chance do individual investors have?

The data suggests that successful stock market investing is not about finding winners—it's about ensuring you don't miss them. The handful of companies that drive overall market returns are not necessarily predictable in advance. Many of today's market leaders were unknown, out-of-favor, or considered risky investments during their early growth phases.

Consider that companies like Amazon, Netflix, or Tesla faced significant skepticism during various points in their development. Conversely, many formerly beloved stocks—think of onetime market darlings like Kodak, Blockbuster, or numerous technology companies from the dot-com era—eventually became wealth destroyers for those who held them individually.

Finding the Winners: The Needle in the Haystack Problem

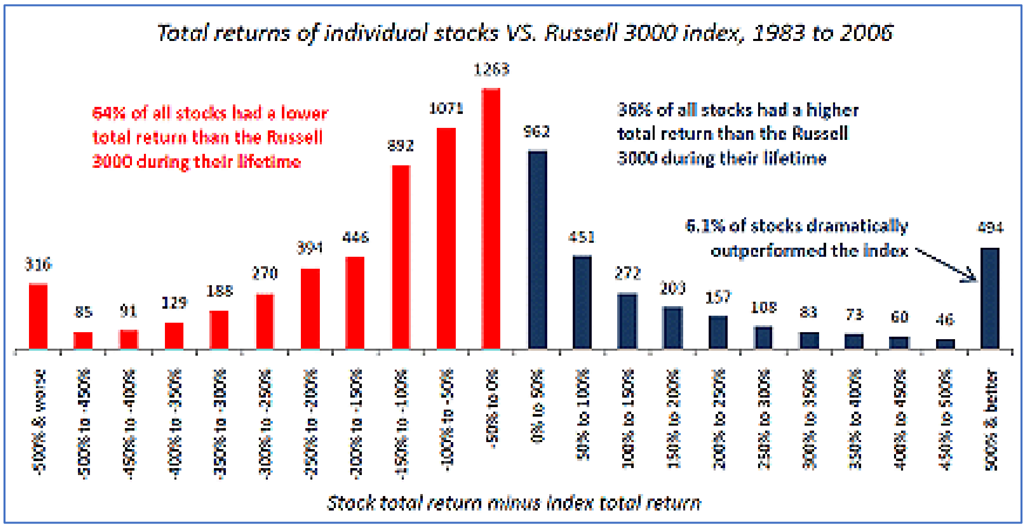
This concentration of returns creates what we might call the "winner's curse" in stock picking. To succeed as an individual stock picker, you must not only avoid the 96% of stocks that underperform Treasury bills, but you must also ensure your portfolio includes a meaningful allocation to the tiny fraction of companies that drive overall market gains.

The mathematical challenge is daunting. Even if you could identify promising companies with above-average accuracy, the odds work against you. Missing just a few of the major wealth creators can devastating impact your long-term returns, while including even a small number of the many wealth destroyers can equally damage your results.

A study entitled *The Capitalism Distribution,* by Eric Crittenden and Cole Wilcox, of the Russell 3000 during 1983-2006 illustrates just how difficult it is to find the next great overachievers. Below are some of the highlights of their study that present a visual representation of just how few of the individual stocks are actually going to be the winners you need to be picking.

Summary Findings by Crittenden and Wilcox

- 39% of stocks were unprofitable
- 18.5% of stocks lost at least 75% of their value
- 64% of stocks underperformed the Russell 3000
- 25% of stocks were responsible for all of the market's gains



The old adage is more true today than ever before: *You do not get paid a return for risk that can be diversified away.* In other words, the only compensated risks are those that cannot be diversified away. This risk is called “systematic risk”, or the risk of the whole system, or stock market itself.

The Popularity Premium Problem

One of the most persistent and costly mistakes individual investors make is paying premium prices for popular stocks. Human psychology naturally draws us toward companies we know, like, and admire. We tend to extrapolate recent good news into assumptions about future performance, and we often confuse a great company with a great stock.

The technology boom of the late 1990s provides a perfect example. Companies like Cisco, Intel, and AT&T seemed like undeniably excellent businesses with bright futures. However, investors who bought these stocks at their peak valuations in 2000 endured years or even decades of poor returns, despite the companies' continued success. The problem wasn't the companies—it was the prices paid.

This phenomenon extends beyond individual stocks to entire sectors and investment styles. Growth stocks, small-cap stocks, emerging market stocks, and other categories experience cycles of popularity that often coincide with peak valuations. Investors who chase these trends frequently buy high and sell low, the opposite of successful long-term investing.

The Buffett Exception: Why One Man's Success Doesn't Prove the Rule

Warren Buffett's investment track record stands as one of the most remarkable achievements in financial history. From 1965 to 2024, Berkshire Hathaway achieved a compound annual return of 19.9%, compared to 10.4% for the S&P 500[13]. Over this 60-year period, Berkshire's stock price increased by more than 5.5 million percent, while the S&P 500 gained "only" about 39,000%[13].

These numbers are so extraordinary that they can mislead individual investors into believing that stock picking represents a viable path to investment success. However, Buffett's achievement actually demonstrates the opposite point: his success is so unusual that it proves how difficult individual stock selection really is.

Why Buffett is the Exception

Several factors explain Buffett's unique success, and most of these factors are not replicable by individual investors. First, Buffett began his career with extensive training under Benjamin Graham, the father of value investing, and started investing professionally in an era when markets were less efficient and opportunities more abundant.

Second, Buffett's success came primarily through controlling ownership stakes in businesses, not through minority stock positions. Much of Berkshire's returns came from operating businesses that Buffett acquired and managed, rather than from traditional stock picking. This approach requires hundreds of millions or billions in capital, operational expertise, and deal-making capabilities far beyond the reach of individual investors.

Third, Buffett has demonstrated almost superhuman insight, discipline and emotional control. He has maintained his investment approach through multiple market cycles, avoiding the psychological pitfalls that trap most investors. He famously ignored the technology boom of the 1990s, despite criticism for missing out on spectacular gains, because those investments fell outside his circle of competence.

The Broader Evidence on Individual Stock Picking

While Buffett succeeded, the broader evidence on individual stock picking tells a different story. Professional mutual fund managers, despite their resources and expertise, struggle to consistently outperform market indexes. According to S&P Global's SPIVA (S&P Indices Versus Active) research, approximately two-thirds of active U.S. equity funds underperformed their benchmark indexes in 2024[12].

If professional money managers with teams of analysts, sophisticated research tools, and institutional advantages struggle to beat the market, individual investors face even longer odds. Academic research consistently shows that individual investors tend to underperform market averages due to behavioral biases, timing mistakes, and selection errors.

Studies have found that individual investors frequently buy high and sell low, chasing performance and making emotional decisions at the worst possible times. They often concentrate their holdings in familiar local companies or trendy sectors, inadvertently increasing risk while reducing expected returns.

One such study was conducted by Dimensional Fund Advisors. DFA found that only about a fifth of stocks survive and outperform the market over 20-year periods. Specifically, only a minority of stocks have achieved significant long-term success, emphasizing the difficulty of selecting winning individual stocks[22]

The Case for Mutual Funds and ETFs

While active professional managers struggle to beat indexes consistently, they do provide valuable services that individual investors cannot replicate. Professional fund managers conduct extensive due diligence, monitor portfolio holdings continuously, and maintain diversification across hundreds or thousands of securities.

Modern index funds and ETFs offer even more compelling advantages. These funds provide instant diversification across entire markets or market segments at extremely low costs. An investor can own a proportional stake in the entire U.S. stock market, or even global markets, with a single fund purchase.

The cost advantage of index funds has become particularly compelling. While individual stock trading has become commission-free at most brokerages, the hidden costs of maintaining a diversified individual stock portfolio—including bid-ask spreads, market impact, and time costs—remain significant. Index funds typically charge annual fees of less than 0.1%, making them extraordinarily cost-effective vehicles for market exposure.

The Behavioral Advantage

Perhaps most importantly, fund-based investing helps investors avoid the behavioral mistakes that destroy returns. When you own an individual stock that declines significantly, the emotional pressure to sell can be overwhelming. When you own a diversified fund that declines, you're more likely to recognize the decline as temporary market volatility rather than a fundamental problem with your investment approach.

Fund ownership also reduces the temptation to engage in harmful trading behavior. Individual stock owners often feel compelled to "do something" when they read news about their holdings or when they see other stocks performing better. Fund owners are more likely to maintain a long-term perspective and avoid costly trading mistakes.

Practical Implementation: Building a Fund-Based Portfolio

Core Holdings Strategy

For most individual investors, a core holdings approach using broad market index funds provides the foundation for long-term wealth building. A simple three-fund portfolio consisting of a U.S. stock market index fund, an international stock index fund, and a bond index fund can provide comprehensive diversification across virtually all investable assets.

This approach ensures participation in the small number of companies that drive overall market returns while avoiding the impossible task of identifying these winners in advance. It also provides exposure to different economic cycles, geographic regions, and market segments without requiring constant monitoring or adjustment.

Satellite Holdings for Specific Exposures

More sophisticated investors might add "satellite" holdings to achieve specific exposures or implement particular investment strategies. Small-cap value funds or emerging market funds, can complement core holdings while maintaining the benefits of professional diversification.

However, these satellite holdings should represent a small percentage of overall portfolios. The core holdings should provide the majority of equity exposure, with satellites adding targeted exposure to specific opportunities or investment factors.

Regular Rebalancing and Dollar-Cost Averaging

Fund-based investing also facilitates two important investment practices: regular rebalancing and dollar-cost averaging. Rebalancing involves periodically adjusting portfolio allocations back to target percentages, which forces investors to sell assets that have performed well and buy assets that have performed poorly—the essence of buying low and selling high.

Dollar-cost averaging involves making regular investments regardless of market conditions. This approach reduces the impact of market timing on investment results and helps investors build wealth consistently over time. Both practices are easier to implement with funds than with individual stocks.

Points to Remember

- The evolution of stock market investing reflects both changing market conditions and growing recognition of the challenges facing individual investors. Several key insights should guide modern investment approaches:

- Diversification requirements have increased dramatically. The traditional model of owning 15-30 individual stocks no longer provides adequate protection against the risks of modern markets. Today's investors need exposure to hundreds or thousands of companies to achieve proper diversification.
- Stock picking is extraordinarily difficult. Academic research shows that only 4% of all stocks outperform Treasury bills over long periods, and a tiny fraction of companies drive overall market returns. The mathematical odds work against individual stock selectors.
- *You do not get paid a return for risk that can be diversified away.* In other words, the only compensated risks are those that cannot be diversified away. This risk is called "systematic risk", or the risk of the whole system, or stock market itself.
- Valuation matters enormously. Even excellent companies can become poor investments if purchased at excessive prices. Popularity often coincides with peak valuations, making beloved stocks particularly dangerous for long-term returns.
- Professional success doesn't translate to individual success. Warren Buffett's remarkable track record represents an exception that proves the rule about stock picking difficulty. Even professional managers struggle to beat market averages consistently.
- Fund-based investing solves multiple problems simultaneously. Mutual funds and ETFs provide instant diversification, professional management, low costs, and behavioral advantages that individual stock picking cannot match.
- Implementation should emphasize simplicity. A core holdings approach using broad market index funds provides comprehensive market exposure without the complexity and risks of individual stock selection.

The shift toward fund-based investing represents not a failure of American capitalism, but its evolution toward greater efficiency and accessibility. By embracing this evolution, individual investors can participate in long-term wealth creation while avoiding the pitfalls that have trapped stock pickers for generations. In an era when picking winning stocks has become harder than ever, the wisdom lies not in trying to beat the market, but in ensuring you capture its returns through broad, low-cost diversification.

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